H.R. 1578, REAL ESTATE INVESTMENT TRUSTS [REITS]: CAN THEY IMPROVE THE THRIFT SAVINGS PLAN?

HEARING

BEFORE THE

SUBCOMMITTEE ON THE FEDERAL WORKFORCE AND AGENCY ORGANIZATION

OF THE

COMMITTEE ON GOVERNMENT REFORM

HOUSE OF REPRESENTATIVES

ONE HUNDRED NINTH CONGRESS

FIRST SESSION

ON

H.R. 1578

TO AMEND TITLE 5, UNITED STATES CODE, TO PROVIDE FOR A REAL ESTATE STOCK INDEX INVESTMENT OPTION UNDER THE THRIFT SAVINGS PLAN

APRIL 19, 2005

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H.R. 1578, REAL ESTATE INVESTMENT TRUSTS [REITS]: CAN THEY IMPROVE THE THRIFT SAVINGS PLAN?

TUESDAY, APRIL 19, 2005

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON FEDERAL WORKFORCE AND AGENCY ORGANIZATION,
COMMITTEE ON GOVERNMENT REFORM,
Washington, DC.

The subcommittee met, pursuant to notice, at 2:02 p.m., in room 2154, Rayburn House Office Building, Hon. Jon C. Porter (chairman of the subcommittee) presiding.

Present: Representatives Porter, Davis, Cummings, Norton, and Van Hollen.

Staff present: Ron Martinson, staff director; B. Chad Bungard, deputy staff director and chief counsel; Chris Barkley and Shannon Meade, professional staff members; Reid Voss, legislative assistant/clerk; Patrick Jennings, detail from OPM serving as senior counsel; Michelle Ash, minority senior legislative counsel; Mark Stephenson and Tania Shand, minority professional staff members; and Teresa Coufal, minority assistant clerk.

Mr. PORTER. Usually, when it is this quiet at my house when I get home, it is usually because the kids have done something wrong. So let me say welcome, and I know that is not the case. I thank you all for being here. I would like to bring the meeting to order. This is a hearing today on the Real Estate Investment Trusts and whether they can improve the Thrift Savings Plan.

Since we do have a quorum present, we will bring the meeting to order. Good afternoon. As you know, last Wednesday I, along with Representative Chris Van Hollen and Representative Tom Davis, our chairman of the Government Reform Committee, introduced the Real Estate Investment Thrift Savings [REITs] Act, H.R. 1578. As a Member of Congress who represents a good share of major growth area in real estate in Nevada and Las Vegas, I think it is very important we look at this issue today, and that is why we brought the bill forward, as an option as investment for the program.

As you know, there are many other programs, not unlike the 401(k) plans. Federal employees are given choices in handling their own retirement planning through the Thrift Savings Plan. The Thrift Savings Plan, however, is lagging behind the private sector in the amount of options it offers its employees in its defined con-

tribution plan. The TSP offers 5 options; whereas the private sector, in some cases, as an average can have close to 16 options.

What we are talking about today is a simple concept and it is called diversification. Basic economic principles dictate that investors should not place all of their eggs in one basket, but must spread their money and risk among different types of assets.

A few years ago, during the tech bubble collapse, many Federal employees experienced setbacks in their investment portfolios and did not have the option to invest substantially in REITs. Federal employees should not be left out in the cold. Adding a Real Estate Investment Trust fund option to the TSP is the next logical step. With its resilient earnings and lower volatility, real estate provides a sound investment over the long haul, such as investment in valuable diversification tools providing the possibility of strong returns and risk reduction.

The demand for Real Estate Investment Trusts among 401(k) investors has been robust, as they seek to diversify their portfolios. In response, the Real Estate Investment Trust stocks are increasingly being added as an investment option by the private sector in their 401(k) plans, including employers such as IBM and General Motors.

It is no wonder. As this month's Forbes reports, in the past 5 years, Real Estate Investment Trusts have outperformed the Standard & Poor's 500, up 19.1 percent annually from the Bloomberg Real Estate Investment Trust Index, negative 3.2 percent for the Standard & Poor's. Moreover, from 2000 to 2003, when the highest total rate of return on any stock fund in the TSP—the C, the S, or the I Funds—was 1 percent, the rate of return on the Real Estate Investment Trusts were near plus 20 percent.

I mention the recent success of the Real Estate Investment Trusts earnings not to raise expectations that the Fund will produce this extraordinary result every year. Rather, it shows that if a Federal employee had invested in a Real Estate Investment Trust Fund in that period of economic downturn, he or she could have avoided what for many was a financial disaster right on the edge of their retirement plan.

I would add that the Thrift Savings Board holds the view that the Real Estate Investment Trusts are an industry and should be viewed like energy, technology, and the like. Interestingly, Barclay's Global Investors, which administers four of the five TSP Funds for the TSP Board, will state in their testimony before us today that the Real Estate Investment Trusts real estate are not an interest, but rather, an entirely separate asset class.

And while I am on that subject, let me also compliment the TSP Board for its work. I had a chance to read the backup testimony, and appreciate the expense ratios and what you have done. Although we may not agree on this issue, let me applaud you for the work that you are doing. We appreciate it very much.

I truly believe that adding a Real Estate Investment Trust to the TSP is a step forward in bringing the benefits of diversification to the TSP and thus enhancing the retirement benefits for all of our hardworking Federal employees.

With that said, I know that there are differences of opinion, as I mentioned, on what the TSP should look like. I look forward to

hearing from all of our witnesses today and thank you for agreeing to join us.

[The prepared statement of Hon. Jon C. Porter and the text of H.R. 1578 follow:]

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Opening Statement of Chairman Jon Porter
Hearing of the House Government Reform Subcommittee on
the Federal Workforce and Agency Organization

"Real Estate Investment Trusts (REITS): Can They Improve the Thrift Savings Plan?"

April 19, 2005

Good Afternoon! Last Wednesday, I, along with Rep. Chris Van Hollen and Rep. Tom Davis, Chairman of the Government Reform Committee, introduced the "Real Estate Investment Thrift Savings Act," or, the "REITS Act" (H.R. 1578). As a member of Congress who represents the greater part of Las Vegas, I know a little something about the importance of having real estate as an option for investment. The proposal before us today is another step in an attempt to make the Federal government an employer of choice.

Like 401(k) plans, Federal employees are given choices in handling their own retirement planning through the Thrift Savings Plan (TSP). The Thrift Savings Plan, however, is lagging behind the private sector in the amount of options it offers its employees in a defined-contribution plan. The TPS only offers 5 options; whereas, the private sector offers an average of 16 options.

What we are talking about today is a simple concept: DIVERSIFICATION. Basic economic principles dictate that investors should not place all of their eggs in one basket, but must spread their money and risk among different types of assets. A few years ago – during the tech bubble collapse – many Federal employees experienced setbacks in their investment portfolio and did not have the option to invest substantially in REITs. Federal employees should not be left out in the cold. Adding a REIT fund option to the TSP is the next logical step. With its resilient earnings and lower volatility, real estate provides a sound investment over the long haul. Such an investment is a valuable diversification tool, providing the possibility of strong returns and risk reduction.

The demand for REITs among 401(k) investors has been robust, as they seek to diversify their portfolios. In response, REIT stocks are increasingly being added as investment options by the private sector in their 401(k) plans, including employers such as IBM and GM. It is no wonder. As this month's *Forbes* reports, "In the past five years real estate investment trusts have outperformed the Standard & Poor's 500: Up 19.1% annually for the Bloomberg REIT index,

negative 3.2% for the S & P." Moreover, from 2000 to 2003 when the highest total rate of return on any stock fund in the TSP (C, S or I Funds) was –0.1%, the rate of return on REITs was near +20%. I mention the recent success of REIT earnings not to raise expectations that a REIT Fund will produce this extraordinary result every year. Rather, it shows that if a Federal employee had invested in a REIT Fund in that period of economic downturn, he or she could have avoided what for many was a financial disaster right on the edge of retirement.

I would add that the Thrift Savings Board holds the view that REITs are an industry, and should be viewed like energy, technology and the like. Interestingly, Barclays Global Investors which administers 4 of the 5 TSP funds, for the TSP board, will state in their testimony before us today that REITs – real estate – are not an "industry" but rather an entirely separate asset class.

I believe that adding a REIT option to the TSP is a step forward in bringing the benefits of diversification to the TSP and, thus, enhancing the retirement benefits for all of our hard-working Federal employees. With that said, I know that there are differences of opinion on what the TSP should look like and I look forward to hearing from all of our witnesses today and thank you for agreeing to join us.

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109TH CONGRESS
1ST SESSION

H. R. 1578

To amend title 5, United States Code, to provide for a real estate stock index investment option under the Thrift Savings Plan.

IN THE HOUSE OF REPRESENTATIVES

APRIL 12, 2005

Mr. PORTER (for himself, Mr. VAN HOLLEN, Mr. TOM DAVIS of Virginia, Mr. FOLEY, Mr. NEAL of Massachusetts, Mr. HOYER, Ms. PRYCE of Ohio, Mr. CANTOR, Mr. LATOURETTE, Mr. WOLF, and Mr. MCHENRY) introduced the following bill; which was referred to the Committee on Government Reform

---

A BILL

To amend title 5, United States Code, to provide for a real estate stock index investment option under the Thrift Savings Plan.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Real Estate Investment Thrift Savings Act".

SEC. 2. REAL ESTATE STOCK INDEX INVESTMENT FUND.

(a) DEFINITION.—Section 8438(a) of title 5, United States Code, is amended—

(1) in paragraph (9), by striking "and" at the end;

(2) in paragraph (10), by striking the period at the end and inserting "; and"; and

(3) by adding at the end the following:

"(11) the term 'Real Estate Stock Index Investment Fund' means the Real Estate Stock Index Investment Fund established under subsection (b)(1)(F).".

(b) ESTABLISHMENT.—

(1) IN GENERAL.—Section 8438(b)(1) of title 5, United States Code, is amended—

(A) in subparagraph (D), by striking "and" at the end;

(B) in subparagraph (E), by striking the period at the end and inserting "; and"; and

(C) by adding at the end the following:

"(F) a Real Estate Stock Index Investment Fund as provided in paragraph (5).".

(2) FUND REQUIREMENTS.—Section 8438(b) of title 5, United States Code, is amended by adding at the end the following:

"(5)(A) The Board shall select an index which is a commonly recognized index comprised of common stock the aggregate market value of which is a reasonably com-

1 plete representation of the United States real estate equity
2 markets.

3 "(B) The Real Estate Stock Index Investment Fund
4 shall be invested in a portfolio designed to replicate the
5 performance of the index selected under subparagraph
6 (A). The portfolio shall be designed such that, to the ex-
7 tent practicable, the percentage of the Real Estate Stock
8 Index Investment Fund that is invested in each stock is
9 the same as the percentage determined by dividing the ag-
10 gregate market value of all shares of that stock by the
11 aggregate market value of all shares of all stocks included
12 in such index.".

13 (c) ACKNOWLEDGMENT OF RISK.—Section 8439(d)
14 of title 5, United States Code, is amended—

15 (1) by striking "or the Small Capitalization
16 Stock Index Investment Fund," and inserting "the
17 Small Capitalization Stock Index Investment Fund,
18 or the Real Estate Stock Index Investment Fund,";
19 and

20 (2) by striking "and (10)," and inserting "(10),
21 and (11),".

○

Mr. PORTER. I would like to now recognize the ranking minority member of the committee, Mr. Davis. Welcome, Mr. Davis.

Mr. DAVIS. Thank you very much, Mr. Chairman. I appreciate it.

Chairman Porter, members of the committee, we are here to discuss a legislative proposal, H.R. 1578, the Real Estate Investment Thrift Savings Act. H.R. 1578 would add a Real Estate Investment Trust to the Thrift Savings Plan. The TSP is a key component of the Federal Employees' Retirement System [FERS]. It is a defined benefit retirement plan similar to the 401(k) plans provided by many employers in the private sector. The income that a retired worker receives from the TSP will depend on the balance in his or her account.

For this reason, I am concerned about the process—how, when, and why—any investment funds, including REITs, are added to the TSP. The act that established the TSP specifically states that the Federal Retirement Thrift Investment Board is to set investment policies and administer the plan "solely in the interest of the participants and beneficiaries."

Indeed, when the Board last added new funds to the TSP, as fiduciaries and managers of the TSP, the Board studied various investment options and transmitted a legislative proposal to Congress that authorized the addition of the S and I Funds to the TSP. Representative Connie Morella introduced the legislation, and it was enacted on September 30, 1995. This is significant because, at this time, the Board and the Employee Thrift Advisory Council do not support adding REITs to the TSP, and the Board has not submitted a legislative proposal recommending that REITs be included in the TSP.

The process by which funds are added to the TSP is important because it goes to the heart of Congress' intent when it created the TSP. In reviewing the legislative history for the establishment of the TSP, one will find this statement: "A great deal of concern was raised about the possibility of political manipulation of large pools of thrift plan money. This legislation was designed to preclude that possibility."

It goes on to say, "The committee considered permitting any qualified institution to offer employee specific investment vehicles. However, the committee rejected that approach for a number of reasons. First, there are literally thousands of qualified institutions who would bombard employees with promotions for their services. Also, even qualified institutions go bankrupt occasionally and a substantial portion of an employee's retirement benefit would be wiped out. This is in contrast to the diversified fund approach which could survive a few bankruptcies."

It is clear that Congress intended to isolate the TSP from political manipulation by creating the Board and emphasizing a diversified, broad-based indexing fund approach for the TSP. Congress envisioned exactly what is happening today, and I do not think we should stray too far from the principles Congress laid out in 1986 when the TSP was created.

Given the political realities, however, I strongly recommend that the Board conduct a comprehensive study of various investment funds, including REITs, and submit a legislative proposal to Con-

gress recommending what funds, if any, should be added to the TSP.

Again, I thank you for calling this hearing and look forward to the witnesses, and I yield back any additional time.

[The prepared statement of Hon. Danny K. Davis follows:]

**STATEMENT OF THE HONORABLE DANNY K. DAVIS
AT THE SUBCOMMITTEE ON FEDERAL WORKFORCE
AND AGENCY ORGANIZATION
HEARING ON**

**REAL ESTATE INVESTMENT TRUSTS (REITS): CAN THEY IMPROVE
THE THRIFT SAVINGS PLAN**

April 19, 2005

Chairman Porter, we are here to discuss a legislative proposal, H.R. 1578, the "Real Estate Investment Thrift Savings Act." H.R. 1578 would add a Real Estate Investment Trust (REIT) to the Thrift Savings Plan (TSP). The TSP is a key component of the Federal Employees' Retirement System (FERS). It is a defined benefit retirement plan similar to the 401(k)

plans provided by many employers in the private sector. The income that a retired worker receives from the TSP will depend on the balance in his or her account.

For this reason, I am concerned about the process – how, when, and why – any investment funds, including REITs, are added to the TSP. The Act that established the TSP specifically states that the Federal Retirement

Thrift Investment Board (the Board) is to set investment policies and administer the plan "solely in the interest of the participants and beneficiaries." Indeed, when the Board last added new funds to the TSP, as fiduciaries and managers of the TSP, the Board studied various investment options and transmitted a legislative proposal to Congress that authorized the addition of the S and I

Funds to the TSP. Rep. Connie Morella introduced the legislation, and it was enacted on September 30, 1995. This is significant, because at this time, the Board and the Employee Thrift Advisory Council do not support adding REITs to the TSP, and the Board has not submitted a legislative proposal recommending that REITs be included in the TSP.

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that possibility." It goes on to say, "The committee considered permitting any qualified institution to offer employee specific investment vehicles. However, the committee rejected that approach for a number of reasons. First, there are literally thousands of qualified institutions who would bombard employees with promotions for their services… [Also], even qualified institutions go bankrupt

occasionally and a substantial portion of an employee's retirement benefit would be wiped out. This is in contrast to the diversified fund approach which could survive a few bankruptcies." It is clear that Congress intended to isolate the TSP from political manipulation by creating the Board and emphasizing a diversified, broad-based indexing fund approach for the TSP. Congress envisioned

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Given the political realities, however, I strongly recommend that the Board conduct a comprehensive study of various investment funds, including REITs, and submit a legislative proposal to Congress

recommending, what funds, if any, should be added to the TSP.

Thank you.

Mr. PORTER. Thank you.

Congresswoman, do you have an opening statement?

Ms. NORTON. Mr. Chairman, I am intrigued by this hearing, and thank you for calling this hearing, because I think it opens up not only an option, but it opens up the opportunity for members to find out, for example, why—I think there are good reasons why—this fund is lacking in the kind of diversification that we find in the private sector. But I need to know why.

I am a big supporter of the TSP. Mr. Chairman, with such a bipartisan bill, I hope you will forgive this partisan note. I would like us to have more hearings like this about how to encourage employers and employees to promote savings for retirement in the way the Thrift Savings Plan does, as opposed to yanking it out of Social Security. So I am really for enhancing the plan to the extent that is consistent with what the Board and the Advisory Board, whose job it is to sit on top of all this, find to be prudent.

Off the top of my head—and we all have to understand that in Congress it is literally off of our heads—you say to me invest in real estate. I said you have me. I am from the school that always believed that investment in real estate and land was more solid than the stock market. This shows how much I know. I am also from the generation that is still a victim of the dot com era—I used to have a shirt back then—but I do think we all learn that what looks good in one period may not be as good in another, which is why the TSP has a reputation for being conservative.

I have to say, Mr. Chairman, I was intrigued by your own opening statement, by what you indicated real estate had done during these very down years, 2000–2003, while we were down in the dumps. That is, what I want to know is, what happened to us? I thought we were supposed to be conservatively invested during that period, and look at that. The difference that you speak of, 20 percent there, and all of us who were invested in TSP were at 0.1 percent. I don't know where the conservatism got us in that regard, because that is where I would have expected us to have done better precisely because the TSP is, as we all know, run in a conservative fashion.

So this might be the right thing to do, and, Mr. Chairman, I think you are doing the right thing, that is to say, having a hearing before we jump. This Board consists of fiduciaries, including their executive director, and I asked my staff to find out something about this Board. I wanted to know if this Board was in any way political, and they tell me that the members don't have to be divided by party; they are all appointed by the current President. The Board is nonpartisan. Of the five Board members, three were appointed by President Bush, one was recommended by Speaker Hastert, and the other was recommended by Senator Stevens. They have staggered terms.

So when this Board tells me go slow, I think we all ought to listen. At the same time, I am concerned if there is less diversification since, again, the standard gospel is that the more diversification the better, of course. There can be a point where diversification, I suppose, counts, but on this matter, whereas my instinct would be to say why not, I think, Mr. Chairman, that I may be the conservative and you may be the liberal here, that I would like

first to hear from the Board before I tell them to risk my money in anything.

So I appreciate this hearing, because it allows us to hear from them and from other witnesses on a very intriguing subject, and I appreciate that you have called this hearing for that reason.

Mr. PORTER. Thank you very much for the kind comments. I, like you, am anxious to hear the testimony and have an opportunity to ask some questions ourselves.

I would like to ask unanimous consent that all Members have 5 legislative days to submit written statements and questions for the hearing record, and any answers to the written questions provided by the witnesses also be included in the record. Without objection, so ordered.

I ask unanimous consent that all exhibits, documents, and other materials referred to by Members and the witnesses may be included in the hearing record, and that all Members be permitted to revise and extend their remarks. Without objection, so ordered.

I ask unanimous consent that written statements from IBM and the Employees' Thrift Advisory Council be submitted for the record. They were invited to speak today but were unable to do so. So, without objection, that is also so ordered.

And it is the practice of the committee to administer the oath to all witnesses, but we will wait a moment and introduce our first panel. Good friends, we appreciate your being here.

First, I would like to introduce Mr. Mark Foley, Congressman from Florida. And with him is Congressman Richard Neal, Representative from Massachusetts. These men are co-chair of the House Real Estate Caucus.

So I begin with Mr. Foley. You are recognized for 5 minutes.

STATEMENTS OF HON. MARK FOLEY, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF FLORIDA, CO-CHAIR OF THE HOUSE REAL ESTATE CAUCUS; AND HON. RICHARD E. NEAL, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MASSACHUSETTS, CO-CHAIR OF THE HOUSE REAL ESTATE CAUCUS

STATEMENT OF HON. MARK FOLEY

Mr. FOLEY. Thank you very much, Mr. Chairman. My fellow colleagues and members of the subcommittee, thank you for inviting me here today to testify in favor of the Real Estate Investment Thrift Savings Act "REITs Act." As co-chairman of the Congressional Real Estate Caucus, I strongly support this effort to bring the explosive growth potential of the real estate market to over 3 million Federal workers and military personnel that participate in the Thrift Savings Plan.

Chairman Porter's bill will increase the investment options available to Federal employees and enhance the retirement security of the Federal work force. In fact, the success of this option in the TSP could act as a model for its expansion into private sector employer-sponsored retirement plans.

Real Estate Investment Trusts have a proven record of success, operating portfolios of investment-grade, income-producing commercial, residential, and industrial real estate. REITs derive a

large portion of their value and most of their reliable income from the rents produced by these tangible assets.

And because REITs pay out virtually all of their income to shareholders, as required by law, their yields are much more impressive than many of the other investment products. In fact, non-industry research has shown conclusively that returns from real estate investments are much higher than those from other investments.

More recent research has shown that investment returns from REITs and the returns from other stocks and bonds make REITs an attractive addition to an individual investor portfolio as well as those of institutional investors. As a result, more and more financial experts are recomending that retirement savings be diversified into stocks, bonds, and real estate.

Until 2001, when the S Fund and the I Fund were added, the TSP contained only three options: the C, the G, and the F Funds. All three were considered to be low-risk investment options over the long term, but the plan was insufficient for proper diversification and so other funds were added. Now is the time to further expand the TSP by adding a REIT fund to those options already available.

Again, subject to the discretion of the investor, myself included, I have diversified my account to all current five funds in thrift savings, and I would welcome the chance, personally, to be able to have a sixth option.

Research by the Federal Retirement Thrift Investment Board, which administers the Thrift Savings Plan, shows that the number of investment options in private sector 401(k) plans continues to increase. The Board reported that the percentage of private sector companies offering 11 or more options to their employees has risen to nearly 70 percent. On the other hand, the percentage of companies offering five or less options—the TSP currently has five options—has dropped to about 1 percent. This makes the Thrift Savings Plan somewhat out of step with the private sector retirement plans.

REITs provide the benefit of diversification and have a proven long-term performance. The old adage of don't place all of your eggs in one basket certainly holds true today. I have always invested a portion of my mother's own personal retirement savings in Real Estate Investment Trusts because I believe them to be not only safe, but a prudent way in which to diversify her own portfolio. I trust them for my mother. I hope I have the trust to be able to invest them myself. I don't, as I say, just recommend these to others; I have invested in my own personal account as well.

Again, I reiterate my support for the chairman's legislation and look forward to its speedy consideration by the full House of Representatives.

Mr. PORTER. Thank you, Congressman. Appreciate your comments. And my best to your mother. Take care of your mom.

Mr. Foley. She is happy, she has a new pope today. She is pleased.

Mr. PORTER. Yes, I am sure she is. Give her our best.

Mr. FOLEY. Thank you.

Mr. PORTER. Next, Congressman Neal.

STATEMENT OF HON. RICHARD E. NEAL

Mr. NEAL. Thanks very much, Mr. Chairman. I want to also join with my friend, Mark Foley, another son of Massachusetts. Of course, one of the reasons that I have defended Social Security so arduously is because of your mom. So I am looking out for her as well as the rest of my constituents of Massachusetts.

Mr. FOLEY. Thank you.

Mr. NEAL. Mark is, I think, the second chairman I have served with on the Real Estate Caucus. I do want to thank you for taking the time to do it, because it really is worthwhile.

Adding a Real Estate Investment Trust [REIT], to the TSP would give Federal workers the opportunity to achieve greater diversification of their investment portfolios, potentially making their investments more stable and more secure. Retirement savings, as we all know, given the debate that is taking place across the country even as we speak, really are a sacred trust. The individuals responsible for designing and administering these plans uphold a precious responsibility: that when people who have worked hard all of their lives reach retirement, the funds that they have invested will be there to sustain them for the next chapter of their life.

When we think about adding another fund to TSP, we should carefully consider a variety of issues, such as whether the dividend income is dependable, long-term performance, whether it is workable administratively, costs associated, and so forth. But the bottom line question that we need to focus on is whether it will help Federal workers achieve retirement security. Is it a good investment tool for them? In the case of REITs, the answer is clearly yes.

Recent history has shown us too many heartbreaking examples of what can happen when people fail to diversify their retirement savings. My clearest memory of Enron and Worldcom scandals is of the interviews with former employees who were left wondering how they would manage after their companies' implosions also took down their retirement savings, and we should never forget that here in Congress, what happened in those instances. It is an extreme example, but it is an important lesson in why workers should be encouraged not to put all of their eggs in one basket.

A REIT investment option would give Federal employees one more opportunity to achieve meaningful diversification of their retirement portfolios. Researchers have determined that returns on real estate investments are appreciably different than the yields from other forms of investment. For example, when the stock market is falling, it isn't necessarily the case that REITs would also be declining. Institutional investors recognize this and routinely include real estate in their portfolios.

Mr. Chairman and members of the committee, I believe REITs would offer Federal workers an outstanding investment opportunity. They combine reliable income with excellent long-term performance and they offer outstanding means of diversifying workers' retirement portfolios. And as this debate, that surely is to captivate us for much of the rest of the year over retirement savings, I think that we might help to set in position a model for what retirement plans ought to look like for the American people.

[The prepared statement of Mr. Neal follows:]

Testimony on Adding a Real Estate Investment Trust Option
to the Thrift Savings Plan
Congressman Richard E. Neal
April 19, 2005

Good afternoon, Chairman Porter and Ranking Member Davis, and to the rest of the committee. I appreciate having the opportunity to be with you today.

I'm here this afternoon with my good friend and colleague, Congressman Foley, in our capacity as co-chairs of the Congressional Real Estate Caucus, to urge the members of the Committee to support giving our federal workers a new real estate investment trust option as part of the thrift savings plan.

Adding a real estate investment trust, or REIT (*pronounced REET*), to the TSP would give federal workers the opportunity to achieve greater diversification of their investment portfolios, potentially making their investments more stable and more secure.

Retirement savings are a sacred trust. The individuals responsible for designing and administering these plans uphold a precious responsibility—that when people who have worked hard all their lives reach retirement, the funds that they have invested will be there to sustain them for the next chapter of their lives.

When we think about adding another fund to the TSP, we should carefully consider a variety of issues, such as whether the dividend income is dependable, long-term performance, whether it is workable administratively, costs associated, and so forth.

But the bottom-line question that we need to focus on is whether it will help federal workers achieve retirement security. Is it a good investment tool for them?

In the case of REITs, the answer is clearly "yes."

Recent history has shown us all too many heartbreaking examples of what can happen when people fail to diversify their retirement savings. My clearest memory of the Enron and WorldCom scandals is of the interviews with former employees who were left wondering how they would manage after the companys' implosions also took down their retirement savings.

It's an extreme example but an important lesson in why workers should be encouraged not to put all their eggs into one basket.

A REIT investment option would give federal employees one more opportunity to achieve meaningful diversification of their retirement portfolios.

Researchers have determined that the returns on real estate investments are appreciably different than the yields from other forms of investment. For example, then, when the stock market is falling, it isn't necessarily the case that REITs would also be declining.

Institutional investors recognize this and routinely include real estate in their portfolios.

Mr. Chairman, members of the Committee, I believe that REITs would offer federal workers an outstanding investment opportunity. They combine reliable income with excellent long-term performance, and they offer an outstanding means of diversifying workers' retirement portfolios.

Thank you for the opportunity to be with you today.

Mr. PORTER. Thank you very much, Congressman. Appreciate your testimony.

And to both of you, I know for years you have been monitoring and working closely with real estate across the country, and we appreciate your expertise today.

I am not sure if there are any questions from the panel.

Mr. DAVIS. Just one.

Gentlemen, thank you both for your testimony and for your articulation of the importance of this legislation and what it will, in all likelihood, do for those of us who participate in it.

Obviously, we are always looking to make sure that investments are as safe and as secure as they can possibly be. An employee could actually put all of their investment into one of these plans, and, of course, if something should happen to it, they could also lose all of their investment. Would you suggest that there might be some restriction on that as a safeguard?

Mr. FOLEY. Well, I like to caution everyone that you have to diversify. I don't like to put percentages on any particular investment portfolio, because you may deny that individual who has knowledge of the marketplace from gaining substantial yields on investment.

In my particular case, though, I found my way to diversify, because there are going to be good years in equities, there are going to be some very bad years. I remember 1999, 2000, and 2001. But with dividend-paying stocks, with Real Estate Investment Trusts, with a mixture of bonds and fixed income, and also doing some things like mutual funds, the average investor can insulate themselves.

I would always be willing, though, to look at some caps on each individual account, because I do think we saw a lot of people in 1999, prior to the meltdown, watching CNBC every 5 minutes, thinking they could outsmart the market and better return investments to their portfolio. Sometimes greed needs to be reined in with logic.

So I always like to see a balanced approach. Again, the old adage—it may be simple—don't put all of your eggs in one basket seems high praise to people who choose a multitude of paths in which to invest.

Mr. NEAL. It is a great question, and I think that it is the lead-in to part of the Social Security debate. I think that is why the certainty of Social Security becomes so important at a date that is predictable. But most importantly, I think this is a lesson that is lost because we forget sometimes of what institutional memory means in this town. I came to Washington in the middle of the S&L crisis, and I watched people sit across the desk from me in my constituent office back in Springfield who didn't know there was a $100,000 on FDIC.

And since an anecdote is such a powerful part of our public lives, I think it always will stand out for me the woman who was trying to raise twins that were retarded, and she had saved $240,000, and came to my office asking how she could get her money back. They were only going to guarantee $100,000.

This is what I think we have to keep perspective on in this debate over retirement savings. If we were sitting here 10 years ago, the same people that would be saying today that it is easy to take

this cautious approach to investment, 10 years ago they would have been saying to us how can you not get into the dot com investment opportunities. They would have been assuring us look what has happened; it is guaranteed forever. Who listens to them any more?

And my point is that I think is such a sound part of investment strategy, as Mark has done a good job of outlining. There is nothing wrong with some risk, but there ought to be some certainty too, and that is how we would balance it.

So I think Mr. Davis asks a very, very appropriate question.

Mr. FOLEY. I guess I could ask a rhetorical one, then. Should the Social Security recipients be all invested in one fund, and that is T bills? And that is one of the questions we would like to explore. I agree there are some inherent risks. My thrift savings account, again, I have the fixed income, the Government bond; C Fund equity; S Fund, small cap; I Fund, international.

I have been here 10 years. Taking all of those years, including the horrible years we suffered, in the most conservative investment I am still at 5.6 percent annualized; the most aggressive, in the C Fund, I am at 11.6 percent annualized. Spread out among those portfolios, I have earned significantly more than we have been able to earn for the Treasury for Social Security.

My last analogy will be my constituents. I represent the fifth largest senior population in America, so this is a very important debate for me. Those very same constituents will drive 3 miles if the CD offered at this bank is one-eighth of a point higher. With their own money they shop prudently, they look for yield and return, sometimes toasters. But at the end of the day they are able to maximize their income by some diversification.

We understand Social Security is a very complexing and concerning equation. When my grandmother died, all she had was Social Security and Medicare. My job as a member of the Ways and Means Committee is to make sure, whatever we do, people like my grandmother will rest in peace and those who are still alive will have the peace of mind knowing it is a solid program.

Mr. DAVIS. Well, I thank you both, and it seems to me that we are saying that this isn't necessarily for the high-rollers, that this is for security, in a sense. And I think that both Social Security, as well as the TSP, requires a certain amount of looking at, as well as analysis and education, and I think some people take the position nothing ventured, nothing gained, or they take the position the greater the risk, the greater the reward. And I think education becomes the key, and I thank you both.

Mr. NEAL. Mr. Davis, could I comment on that? You are absolutely right, but I just want to harken back to that point that I made about dot coms. The same forces in this town that were agitating for expanding the opportunity of the stock market and Social Security a decade ago, they would have been agitating to put this money in the thrift savings account into more aggressive opportunities. They are gone, and I think that is what we have to be mindful of.

I think the anecdote that Mark used is right on target: his grandmother. All she had was Social Security and Medicare. And I think that, with us, adding on opportunities for people, again, em-

phasizing the term add on, makes a lot of sense, but I hope that we don't forget the world of the dot com bust, Worldcom, Enron, and the S&Ls.

Mr. DAVIS. Thank you.

Mr. PORTER. Well said. Thank you, gentlemen. Appreciate your testimony.

As is customary for the committee, we would now like to perform the oath for all witnesses, administer the oath. So if all the witnesses would please stand.

[Witnesses sworn.]

Mr. PORTER. Let the record reflect all the witnesses have answered in the affirmative. Please be seated.

I would like to call on our second panel, Mr. Saul and Mr. Amelio.

For some of you that have not attended any of my subcommittee hearings, I have jokingly always said we are going to meet in Las Vegas next year. Let me assure you that we have a dry heat in Las Vegas, and we appreciate that it is warming here, but we kind of like the dry in the west. Welcome.

Mr. SAUL. I accept the invitation.

Mr. PORTER. Well said. Thank you.

First of all, the Honorable Andrew Saul is chairman of the Federal Retirement Thrift Investment Board. Would you like to present your testimony?

STATEMENTS OF ANDREW M. SAUL, CHAIRMAN, FEDERAL RETIREMENT THRIFT INVESTMENT BOARD; AND GARY A. AMELIO, EXECUTIVE DIRECTOR, FEDERAL RETIREMENT THRIFT INVESTMENT BOARD

STATEMENT OF ANDREW M. SAUL

Mr. SAUL. Thank you, Mr. Chairman.

Good afternoon, Mr. Chairman and members of the subcommittee. My name is Andrew Saul, and I am the chairman of the Federal Retirement Thrift Investment Board. The Board administers the Thrift Savings plan for Federal employees and members of the uniformed services.

I am accompanied today by Gary Amelio, the Board's Executive Director. My four fellow Board members and I serve in a part-time capacity. Gary serves as the full-time Chief Executive Officer of the agency. The five Board members and the Executive Director are established by statute as the plan fiduciaries and, as such, are required to act solely in the interest of Thrift Savings Plan participants and beneficiaries.

When Gary and I last appeared in this room to present testimony in July 2003, we were newly appointed to our positions and in the midst of implementing a new TSP recordkeeping system. In response to concerns expressed by Committee Chairman Tom Davis and other Members, I provided assurances that the new system would dramatically improve service to participants. This has been done. Transactions which used to take up to 6 weeks are now executed each day. The ThriftLine queues have been eliminated. Web-based access has been dramatically expanded and operates in less

than a third of the pre-conversion time, and the transaction capacity has been increased exponentially.

After implementing the new system, the Board approved Gary's plan to continue to drive service levels up and costs down on all fronts. The TSP data center was upgraded for speed and capacity tenfold and a backup facility which can be activated within hours to provide seamless service has been brought on-line. We instituted a parallel call center to improve response times and ensure uninterrupted service during emergencies.

Calls are now routinely answered within the service standards of the largest and best private sector providers. For the first time we are in the process of soliciting bids for recordkeeping services, thus ensuring that participants are getting the best quality and price the competition can secure. Agency staff has been reduced by 10 percent through attrition and our budget has been reduced by $15 million, about 14 percent. This is especially important since participants pay the costs of running the plan and these savings all accrue to their bottom line account balances.

The total cost of the TSP for plan participants was down to 6 basis points or 60 cents per $1,000 of account balance in 2004. This includes both the asset management and administrative expenses. Gary is promising to bring costs down even further, perhaps by another 15 percent, this year. And, by the way, the Board will hold him to that. In terms of industry comparisons, we are off the charts when it comes to preserving participants' funds in their accounts rather than spending them on unnecessary administrative expenses or investment fees.

We have aggressively pursued our statutory obligation to develop policies which are suitable for long-term investment. We have reviewed the performance of the current TSP investments each calendar quarter and have expanded ongoing efforts to remain current on industry practices. The other Board members and I have conducted due diligence site visits to our major vendors. Where appropriate, Gary and the agency staff have met with industry and government officials, conducted site visits at facilities run by the major national financial service providers, and kept the Board members fully appraised.

At Gary's recommendation, we have established the most important new TSP investment policy in at least 10 years by approving five new Lifecycle Funds for the TSP. These funds, which debut this summer, will provide participants with the benefits of professional asset allocation. Consistent with the fundamental policy twice approved in statute by the Congress, these investments will use the broad-based index and government services [sic] funds now offered by the TSP. Once in place, the Lifecycle Funds will generate no additional charges to participants other than the minimal costs for periodically reviewing the asset allocation model design.

As would occur with the introduction of any new fund, there will be costs for systems modifications as well as substantial costs associated with the comprehensive design, development, and distribution of materials to educate participants. Indeed, we have budgeted $10 million for this effort, in recognition of both its critical importance and the enhanced focus on financial literacy established by the Congress last year in Public Law 108–469.

The education effort will be designed to meet what we consider to be the major challenge for TSP investors: optimizing investment performance by aligning the individual's risk/return profile with his or her investment horizon. In the financial world, this is known as investing on the "efficient frontier." We are very excited about the prospect of providing the Lifecycle Funds to participants and would be pleased to discuss this initiative in detail at the appropriate time.

The purpose of this hearing is to discuss an investment that in many ways is quite different from the existing TSP investments. The Real Estate Stock Index Investment Fund proposed in H.R. 1578 would establish an index fund exclusively comprising Real Estate Investment Trust securities. Simply stated, for the TSP this would be the wrong fund at the wrong time.

First, investment policy should not be developed one fund at a time on a case-by-case basis. Sound investment policies can only be developed in a comprehensive fashion.

Second, investment policy should not be developed absent consideration of fundamental plan design issues. We are well aware of the arguments for over-weighting in risk-optimized portfolios. However, including REITs would represent a departure from the very broad asset classes offered by the TSP and endorsed by Congress in the past.

Third, at this time, it is essential that we focus participants' attention on the Lifecycle Funds that we are introducing this summer.

Over the past year, the Board has been kept apprised of the interest expressed in REITs by both the Congress and the industry representatives. Gary and the agency's professional staff have met with industry representatives, received the industry association's analysis, and performed an independent review of that analysis for the Board. They have also met with congressional staff and shared with the subcommittee the results of their review. The Board strongly endorses the open process in which the Executive Director and the agency's professional staff engaged the proponents of a REIT fund, as well as the findings and conclusions of the review by the professional staff.

For the reasons detailed in that review, as well as what I have said and Gary will say today, the Board unanimously recommends against the addition of a REIT fund at this time.

Mr. Chairman, I will conclude my remarks at this point and ask that the remainder of my statement appear in the record. Thank you.

[The prepared statement of Mr. Saul follows:]

Statement of the Honorable Andrew M. Saul, Chairman
Federal Retirement Thrift Investment Board
Before the House Subcommittee on the Federal Workforce and Agency Organization
April 19, 2005

Good afternoon Mr. Chairman and Members of the Subcommittee. My name is Andrew Saul and I am the Chairman of the Federal Retirement Thrift Investment Board. The Board administers the Thrift Savings Plan for Federal employees and members of the uniformed services. I am accompanied today by Gary Amelio, the Board's Executive Director. My four fellow Board members and I serve in a part-time capacity. Gary serves as the full-time Chief Executive Officer of the Agency. The five Board members and the Executive Director are established by statute as the Plan fiduciaries and, as such, are required to act solely in the interest of Thrift Savings Plan participants and beneficiaries.

When Gary and I last appeared in this room to present testimony in July 2003, we were newly appointed to our positions and in the midst of implementing a new TSP record keeping system. In response to concerns expressed by Committee Chairman Tom Davis and other members, I provided assurances that the new system would dramatically improve service to participants. This has been done. Transactions which used to take up to six weeks are now executed each day. The ThriftLine queues have been eliminated. Web-based access has been dramatically expanded and operates in less than a third of the pre-conversion time, and the transaction capacity has been increased exponentially.

After implementing the new system, the Board approved Gary's plan to continue to drive service levels up and costs down on all fronts. The TSP data center was upgraded for speed and capacity ten-fold and a back-up facility which can be activated within hours to provide seamless service has been brought on line. We instituted a parallel call center to improve response times and ensure uninterrupted service during emergencies. Calls are now routinely answered within the service standards of the largest and best private sector providers. For the first time we are in the process of soliciting bids for record keeping services, thus ensuring that participants are getting the best quality and price that competition can secure. Agency staff has been reduced by 10 percent through attrition and our budget has been reduced by $15 million, about 14 percent. This

is especially important since participants pay the costs of running the Plan and these savings all accrue to their bottom line account balances.

The total cost of the TSP for Plan participants was down to 6 basis points or 60 cents per $1,000 of account balance in 2004. This includes both asset management and administrative expenses. Gary is promising to bring costs down even further, perhaps by another 15 percent, this year. In terms of industry comparisons, we are off the charts when it comes to preserving participants' funds in their accounts rather than spending them on unnecessary administrative expenses or investment fees.

We have aggressively pursued our statutory obligation to develop policies which are suitable for long-term investment. We have reviewed the performance of the current TSP investments each calendar quarter and have expanded ongoing efforts to remain current on industry practices. The other Board members and I have conducted due diligence site visits to our major vendors. Where appropriate, Gary and the Agency staff have met with industry and government officials, conducted site visits at facilities run by the major national financial services providers, and kept the Board members fully apprised.

At Gary's recommendation, we have established the most important new TSP investment policy in at least 10 years by approving five new Lifecycle Funds for the TSP. These funds, which debut this summer, will provide participants with the benefits of professional asset allocation. Consistent with the fundamental policy twice approved in statute by the Congress, these investments will use the broad-based index and government securities funds now offered by the TSP. Once in place, the Lifecycle Funds will generate no additional charges to participants other than the minimal costs for periodically reviewing the asset allocation model design.

As would occur with the introduction of any new fund, there will be costs for systems modifications as well as substantial costs associated with the comprehensive design, development, and distribution of materials to educate participants. Indeed, we have budgeted $10 million for this effort, in recognition of both its critical importance and the enhanced focus on financial literacy established by the Congress last year in Public Law 108-469. The education effort will be designed to meet what we consider to be the major challenge for TSP investors, i.e., optimizing investment performance by aligning the individual's

risk/return profile with his or her investment horizon. In the financial world, this is known as investing on the "efficient frontier." We are very excited by the prospect of providing the Lifecycle Funds to participants and would be pleased to discuss this initiative in detail at the appropriate time.

The purpose of this hearing is to discuss an investment that in many ways is quite different from the existing TSP investments. The Real Estate Stock Index Investment Fund proposed in H.R. 1578 would establish an index fund exclusively comprising Real Estate Investment Trust (REIT) securities. Simply stated, for the TSP this would be the wrong fund at the wrong time:

- First, investment policy should not be developed one fund at a time on a case-by-case basis. Sound investment policies can only be developed in a comprehensive fashion.

- Second, investment policy should not be developed absent consideration of fundamental plan design issues. We are well aware of the arguments for overweighting in risk-optimized portfolios. However, including REITs would represent a departure from the very broad asset classes offered by TSP and endorsed by Congress in the past.

- Third, at this time, it is essential that we focus participants' attention on the Lifecycle Funds that we are introducing this summer.

Over the past year, the Board has been kept apprised of the interest expressed in REITs by both the Congress and industry representatives. Gary and the Agency's professional staff have met with industry representatives, received the industry association's analysis, and performed an independent review of that analysis for the Board. They have also met with Congressional staff and shared with the Subcommittee the results of their review. The Board strongly endorses the open process in which the Executive Director and the Agency's professional staff engaged the proponents of a REIT fund, as well as the findings and conclusions of the review by the professional staff.

For the reasons detailed in that review, as well as what I have said and Gary will say today, the Board unanimously recommends against the addition of a REIT fund at this time.

If new investment funds are to be offered by the TSP, consideration must be given to the appropriateness and investability of any new type of investment, how well that type of investment complements the current mix of investment funds, and how it compares with other possible additions and/or deletions.

TSP participants already have more than $1.1 billion invested in REIT securities through our broad-based index investment funds. The REIT proposal is premised on the view that investors could achieve more diversification by holding a higher percentage of REIT securities than is currently provided in the market weightings of the Common Stock Index Investment (C) Fund or the Small Capitalization Index Investment (S) Fund. However, if one were attempting to devise a more diversified portfolio, several classes of assets are now completely unrepresented in the current TSP investment options. Such asset classes include high-yield debt, inflation-protected bonds (TIPS), commodities, and emerging market equity. Some TSP participants might also benefit from the ability to overweight their TSP portfolios toward growth stocks or toward value stocks (i.e., "tilt" their portfolios), which could be accommodated by offering growth and value index funds. All of these options should be considered in addition to REITS in any evaluation of additional funds.

Further, the policy and practical impact of offering "slices" of the markets at the same time we already offer the total market through the existing broad-based index funds previously authorized by the Congress requires very careful consideration. This is particularly important in the case of REITs, because a separate REIT fund would, for the first time, expose TSP participants to overlapping investment choices.

In the long term, the statutory responsibility of Board members to develop TSP investment policies requires continued evaluation of existing TSP funds and consideration of additions from the broad universe of available options. We will balance the possible benefits of additions to the Plan against concerns that too many offerings might complicate education or administrative activities, or lead to investor behavior that is deleterious to long-term financial security. In terms of priorities, our plan is to install the Lifecycle Funds in the TSP, evaluate the impact of the TSP's education efforts and the new funds on participant behavior (including a participant survey later this year), and evaluate other potential funds/asset classes along with the existing offerings.

A broad and considered approach such as this is the way in which the Congress identified the need for, and ultimately authorized, the current TSP investment funds. We recommend that this highly successful approach be continued. If and when new investment funds are an appropriate addition, please be assured that the Plan's fiduciaries would indeed recommend Congressional action (as was done with the S and I Funds) or take administrative action (as we are doing with the Lifecycle Funds).

Mr. PORTER. Thank you, Mr. Saul.

Before we move on, Mr. Amelio, co-sponsor of the original bill, Chris Van Hollen.

Sir, would you like to have an opening statement?

Mr. VAN HOLLEN. No, thank you, Mr. Chairman. I am pleased to join with you in introducing this legislation. I look forward to the testimony of the witnesses. Thank you.

Mr. PORTER. Very good. Thank you.

Next I will introduce Mr. Gary Amelio. I know you had a warm introduction already, but Executive Director of Federal Retirement Thrift Investment Board. Welcome.

STATEMENT OF GARY A. AMELIO

Mr. AMELIO. Thank you, Mr. Chairman, members of the subcommittee. My name is Gary Amelio. Since June 1, 2003, I have served as executive director of the Federal Retirement Thrift Investment Board. Before coming to the Board, I had 23 years of private sector experience in the employee benefits, tax, and fiduciary industry. I appear before the subcommittee today with extensive professional experience.

My mission is to apprise the subcommittee of the unanimous position of the TSP fiduciaries, being the five Board members and myself, to oppose legislation which would add a REIT fund to the plan. Our position is neither a commentary on the investment worthiness of REITS, nor a permanent edict.

A fiduciary must exercise the highest degree of skill and care when considering changes to the plan's investment options. The universe of available investment options should be evaluated to determine whether any alternatives might be added or taken away. This in total review is a necessary fiduciary function.

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

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

Furthermore, adding a fund to the plan is not a "freebie." It could increase the expenses for participants by as much as 10 percent, that is $8 to $10 million, to engage contractors to modify the TSP's Web site, its recordkeeping and participant statement systems, as well as to create new brochures and forms while destroying the existing forms.

The fiduciaries have determined that the cost of the Lifecycle Funds rollout which is currently underway is money well spent since it educates the participants about the importance of asset allocation. Even those participants who choose not to utilize Lifecycle

Funds will benefit from the educational materials. There is no commensurate benefit in communicating a narrow, industry specific product.

The fiduciaries' fund selection process is, of course, based upon need and demand. The Thrift Savings participants already hold over $1 billion in REITs through the C and S Funds, making our plan the 13th or so largest holder of REITs in the country, i.e., the need is already met. As for demand, there is no use adding a fund that no one wants. I receive many letters, e-mails, and calls from the 3.4 million participants who are quite willing to share their thoughts about the plan with me. In my nearly 2-year tenure, I have received only one letter concerning REITs.

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

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

Moreover, the agency has already received an expert opinion concerning the need for additional funds. Mercer Investment Consulting, the expert we selected to develop Lifecycle asset allocation models, examined the current TSP fund options to determine if they provided adequate diversification for TSP participants. They affirmed that the current funds provided diversification and that no other funds were needed at this time.

The next paragraph is very important.

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

That concludes my remarks, and I ask that the remainder of my written statement appear in the record. Thank you.

[The prepared statement of Mr. Amelio follows:]

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

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

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

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

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

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

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

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

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

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

In deciding whether to offer Lifecycle Funds for the TSP, we first issued a Request for Information, seeking input from major investment consultants, banks, and mutual fund managers. We asked all of these organizations the same question: whether the current TSP fund lineup offered our participants adequate opportunities for diversification in their accounts and, by extension, in the Lifecycle Funds. Every organization affirmed that the current TSP fund menu offered such diversification and

that additional funds were not required. Several of the organizations affirmed that the current TSP fund options offered not only adequate but ideal diversification.

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

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

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

The professional staff analysis of the numbers used to justify the overweighting in REITs found that the potential benefits of doing so were overstated. In fact, the additional returns that the REIT industry cited as being achievable assumed a 40 percent allocation in REITs, and were based entirely on investment hindsight. No investment professional would recommend

such a weighting. Further, conclusions about fund performance cannot be based on hindsight, but rather upon assumptions about future economic performance.

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

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

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

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

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

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

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

Mr. PORTER. Thank you for your testimony.

Now I would like to open it up for questions.

Regarding the cost factor, I know that is in your backup and in your testimony, you previously made cost comparisons between F Fund and the REIT Fund when drawing conclusions about how much a REIT Fund would cost. But Barclays has compared the S Fund to the REIT Fund in some ways. Wouldn't it be more appropriate, then, to compare the S and the REIT for the cost purposes?

Mr. AMELIO. Well, if you look at the cost—first of all, we are, I believe, the cheapest legal investment in the world. When I got here, back to 1996, we were at about 7 basis points.

Mr. PORTER. Less expensive. How about that?

Mr. AMELIO. I am sorry, sir?

Mr. PORTER. Less expensive.

Mr. AMELIO. Less expensive, yes. It sounds better than cheapest. Sorry, Congressman.

We have since got down. Last year we were down to 5.83 basis points. This year we are projecting we will be at about 5. Those costs are 100 percent of the plan's costs, administrative as well as investment, and I have to tell you the investment piece of that is very small. If we go out and were to competitively bid and bring a REIT in—and, by the way, those charges are across the board for the five existing funds—of course, I don't know exactly what competitive bidding would yield, but, just based upon generic discussions, we have reason to believe that the management fees alone would be somewhere in the 10 to 20 basis point range.

Now, we may find that we get someone to bid lower than that. We may find the bid higher. We just don't know until competitive bidding. But if you assume 10 basis points versus what we are paying now, that particular fund would be somewhere in the 15 to 25 basis point range versus the existing 5 funds, and it is just way out of sync with the existing 5 funds.

Mr. PORTER. You also have a comment that may be confusing by adding additional funds. From what little I have seen to date on the Lifecycle Funds, it seems like that is going to add additional complexity also. Is there a reason why it will not be confusing as the REIT would be in your argument in your white paper?

Mr. AMELIO. When you have 3.4 million participants around the globe, anything you do to the plan is complex in terms of communicating. But we have an extensive education effort, which actually Congress asked us to do last year in conjunction with OPM, and what we are going to roll out is asset allocation in general, as well as Lifecycle. I wouldn't portend that it is not complex, it is simply that it is much broader education, because when you talk about Lifecycle, you are talking about overall retirement needs.

Mr. PORTER. Yes, Mr. Saul.

Mr. SAUL. Mr. Chairman, I would just like to answer the question that you just asked from my own behalf. The thing that always has impressed me about the Thrift Savings Plan—and I am a professional investor in my private life—when I came here, I couldn't understand how we offered so few choices. After spending 3½ years here, I think that is the strength of this plan.

The fact is we have people that are very dedicated to their professions, 3½ million of them, some in the military, some sitting

around this room, a lot of people sitting around this room, that have a lot of things to do, and they are not professional investors. And I think that when you have a plan that is simple like this but very broad-based, you must remember that if you look at all the options, the five options that we give, it is pretty inclusive, everything from investing in stocks in Great Britain to investing in small Russell 2000 stocks, small companies, to buying all different kinds of bonds, whether they be corporate bonds, or government-issued bonds, foreign government bonds.

We have a money market fund and, of course, we have the S&P 500. We have a lot of real estate stocks in the S&P 500 and the small cap fund. This is a very, very broad-based group of indexes and choices that we issue to people that are not that sophisticated, for the most part, in investing.

The Lifecycle Funds do not add any complexity to this thing. As a matter of fact, it takes away the complexity because what it is doing is doing the asset allocation for people that may be intimidated by the chore of investing their money. We are not adding any more plans at all. We are not adding any more to the menu by adding Lifecycle Funds. All we are is actually adding an asset allocator that will make it much easier for the average participant, I feel, to invest his money.

So I just want to sum this up, and I know it is a long-winded answer, but I think it is very important. I think if you look at our plan, the strength of our plan is the fact that it has limited choices but a full range of options within those choices because of the broad base of financial markets that our plan covers.

Mr. PORTER. One of the reasons that I encourage the passage of the bill is this allows everyone to have an oportunity to invest in real estate. There are a lot of folks in the country that are in a financial position to do it on their own. This gives everyone an opportunity within the plan. But when we look at the returns, take the G Fund from 2000 to 2004, it was 5 percent; the I Fund was 1.2 percent; F Fund, 7.8 percent; the C Fund a 0.8; the S Fund 3.6; and you look at the REIT Funds, we are at 22.4 percent. So is there a reason that you haven't moved forward with REITs in the past?

Mr. SAUL. First of all, I think the important thing in looking at this plan is to look at the results over a longer period of time rather than 5 years. I think that you really have to go back, take a period from 1988 to now, where we have accurate statistics on the plan, and take a look at the returns there. Any one of the plans can do well at any shorter period in the cycle, there is no question about that.

But what you really want to do is if you have somebody that is a young person that is investing in this plan, he is 25 years old, hopes to work until normal retirement age, you really want to see how he does over the long period of time. And I think if you look at these broad-based choices, which, by the way, I am not against real estate, I own personally a lot of real estate. I want you to know that. It is a bedrock of the U.S. economy.

And I do think that we have that included in the broad-based funds that we have now. But I don't think it is accurate, and I would caution against picking out any one investment over a short

cycle and see how it does. I think the real thing is to take a look at it over a longer period of time and then see how it does.

Mr. PORTER. And I know I am actually using more than I am entitled to, but just to followup. In the past 30 years the REITs have out-performed the Standard & Poors. If you look from 1988 to 2004, the Real Estate Investment Trusts have returned about 14 percent since 1988. So we are looking at the long-term, and these numbers actually came from the Ibbotson Associates. So I think we have some disagreement, and we will have some more time to get back to that, OK?

And as far as the information, it came from the Board itself. Thank you.

Mr. Davis.

Mr. DAVIS. Thank you, Mr. Chairman.

Chairman Saul, you indicate that investment policy should not be developed one fund at a time on a case-by-case basis, that it has to be, or certainly should be, comprehensive. Does that mean that once you have established a plan, that in all likelihood you would not add, detract, or subtract at some point?

Mr. SAUL. I think that as fiduciaries we look at this thing on a quarterly basis. I think that you have to—business is evolutionary, the U.S. economy is evolutionary. Things are changing all the time. I think that the duty of the fiduciaries, and why I have been chairman, we look at this quarterly, monthly, is to look at all possibilities.

And I think you are absolutely right, we are talking about the possibilities, and I think there are possibilities there, things in the future. Any prudent businessman would feel that way.

I think you would also want to look at the offerings that you have, and I think that Gary said that in his testimony, that we would constantly look at the existing plans and see if they should be changed in any way. I think you are absolutely correct in that assumption. I think the whole plan has to be constantly evaluated on an ongoing basis.

Mr. DAVIS. Notwithstanding the fact that real estate has been fairly strong. I think of my own city, especially in much of my district, which is Downtown Chicago and within the Loop area, I mean, things are simply booming. I mean, they are going great guns.

So it would seem like, in a sense, that since there is a level of stability—and I just returned, say, from China a couple weeks ago, and real estate was pretty hot there as well; finding a place to live. And, of course, in Japan it is pretty good too. Certainly notwithstanding these market conditions, you still wouldn't recommend?

Mr. AMELIO. I believe it is absolutely the wrong reason to make an investment decision. It is using the rifle approach target, almost stock picking. Virtually all professional asset managers, investment managers will tell you that asset allocation, rather than stock picking, is the way to go, particularly for unsophisticated investors. What we have are broad-based funds that cover every food group of investment in this country, if not the world, and that offers the best protection over the long term.

I am not saying there isn't a better investment option out there, Congressman. There might be, and this one might have had a great

run. And if you lived in Houston a few years ago, Enron had a better run. But eventually all great individual things could come to an end. And I am not saying this would. We are not being critical of REITs, we are just saying broad-based and asset allocation is the way prudent 401(k) providers have to look at this.

Mr. DAVIS. Do you normally hear from participants a great deal? You indicate that you haven't heard much from participants suggesting that we move in this direction. Do you hear from participants about anything? I am saying at all. Do you hear from them? So is this an unusual circumstance or you just don't hear from them?

Mr. AMELIO. Actually, I get a great deal of feedback. The participants aren't shy, as many of you are aware, especially those with districts with a lot of Federal employees. Two years ago we got over 25,000 letters when we had the recordkeeping problem. I get contact in one of many ways: we get letters, e-mails, phone calls, and sometimes it is heavy. I do a lot of speaking myself to participants. I go out all over the country and I speak to large groups of participants, as many as several hundred at a time. Next week I will be seeing about 500.

And I get a lot of feedback. And most of it really is along the lines—they are very fee conscious. I am hearing an awful lot about these Lifecycle Funds. They feel they want more assistance in terms of getting educated for when they retire. But I have only got one letter on this subject in 2 years.

Mr. DAVIS. Thank you very much.

Mr. AMELIO. Yes, sir.

Mr. PORTER. Congresswoman.

Ms. NORTON. Thank you, Mr. Chairman.

Given your testimony from an independent board, all appointed by Republicans, I am disinclined to say it would be adverse to expanding investment opportunities. So I approach this whole hearing, as I do most hearings in Congress, simply with a sense of skepticism about both sides so I can make up my mind.

I was on this committee in 1996, when the S and I Funds were at it. Now we are into more than 10 years, and no new funds. Did we reach nirvana then? Have we reached perfection in the last 10 years? One might ask why it took us so long to get to the S and I Funds. Perhaps you can—particularly since you say—I guess it is in your testimony, Chairman Saul, you indicate that there has already been an independent review.

You talk here about yet another study, but you indicate on page 3 of your own testimony that you are offering this testimony after doing an independent review and analysis for the Board. So I am not sure, first, what the new—I take it that you probably looked only at REITs, and maybe you were looking at the whole thing when you did your own independent review. But I can't tell the difference between what you have already done and what you propose to do.

I can't tell what made you go to S and I Funds, but reluctant to go further at this time, particularly when you talk about transaction costs, since every time you do it there are going to be transaction costs, I suppose. So I suppose I am asking how do you operate. How do you decide when, if ever, to diversify further, particu-

larly bearing in mind that you can't make money without investing some money. So we know it is going to cost you something if you add to the funds, as it must have cost you something in 1996.

Go ahead.

Mr. AMELIO. You have a lot of questions in there. I will talk fast.

First of all, I want to say this under oath. I am appointed by the Board, not by the President. I am——

Ms. NORTON. No, I know. The Board is appointed by the President and by the Speaker.

Mr. AMELIO. The Board, in 2 years, has never brought politics into the TSP setting, and I want that on the official record under oath. Never once. And I want to make sure I make that clear.

Second thing is with respect to the consultants, the consultant that we talk about and the others that we interviewed did that in terms of the Lifecycle Funds in looking at our existing mix, and they did not look specifically at REITs, they gave us their investment opinion, Mercer did, in terms of looking at the Lifecycle Funds.

The last study we talk about on the last page of my testimony, that paper is the Board and I have already decided——

Ms. NORTON. Well, just a moment, Mr. Amelio.

Mr. AMELIO. Yes, ma'am.

Ms. NORTON. The testimony of the chairman specifically says the Board has been kept apprised of the interest expressed in REITs by both Congress and the industry. Gary and the agency professionals have met with industry, received the industry, and performed an independent review. This testimony clearly, it seems to me, refers to REITs, not to Lifecycle or the rest of it.

Mr. AMELIO. We also did an—we at the plan did an independent analysis of REITs. We have got four different studies here that we are talking about. We did do an independent analysis of REITs. Mercer had nothing to do with this study. Mercer put the asset allocation for us together on the Lifecycle Funds. That is independent from the letter I sent to the subcommittee staff about REITs, they are completely unrelated.

Ms. NORTON. Yes, but I am asking about REITs. And it says the agency's professional staff engaged the proponents of a REIT fund, as well as the findings and conclusions of the review by the professional staff.

So the study I am interested in is the study that apparently has already been done, and that is the independent review on page 3 of Mr. Saul's testimony. Does that mean that you have already looked at REITs? If you have, what is this new look you are going to give and how is it different from what you have already done, which apparently has made you conclude that we shouldn't do REITs at this time?

Mr. AMELIO. We did an analysis of REITs on a one-on basis, in other words, looking specifically at REITs directly in response to the subcommittee's request. However, the fiduciaries have decided to now go beyond that, engage a professional investment consultant to look at the universe of investments, which would include REITs. We haven't eliminated it, we just want to look at everything in total, as I mentioned, rather than simply look at a standalone, up or down vote on one fund. We want to look at everything.

Ms. NORTON. I see. Now, you say we are already into REITs, and the difference between what we are into is standalone REITs versus what we are into. How much REITs are we into?

Mr. AMELIO. $1 billion.

Ms. NORTON. Of REITs alone?

Mr. AMELIO. $1 billion of REITs alone sit in—well, they are part of the C and the S Fund; 8 percent of the plan.

Ms. NORTON. Well, let me ask you this. The chairman pointed to some initial figures over the short-term that were very impressive. Then you challenged him about long-term investments. Then he quoted some long-term figures that were equally impressive, which makes me want to know why we did so poorly between 2000 and 2003 if we are so invested in REITs. Where REITs, at least during that period, when everything else was in the valley, were going up. REITs didn't look like it helped us then, so I don't know what $1 billion means, $1 billion out of whatever. Perhaps you should tell me $1 billion out of what is the total amount.

Mr. AMELIO. $155 billion.

Ms. NORTON. Out of $155. Well, no wonder it didn't help us much. Maybe that is why some people want REITs by themselves.

I was not satisfied with your response, because the chairman challenged you again about the long-term returns on real estate. It kind of reinforces the stereotype all of us have about real estate, where real estate did better than the traditional stock. And yet you seem reluctant on REITs, and you are so little invested in REITs, that when you were going down the drain and, by the way, taking all of the rest of us with you in 2000 to 2003, we were dependent upon you all to do much better since all of us didn't have the sense that we thought you had, and we were all into dot coms. You must have been into them too.

I am wondering why, given the track record with REITs and the track record in which you are already in, the long-term track record and the track record for REITs, when everything else was going down, I am trying to understand your reluctance on REITs in particular.

Mr. SAUL. I think you ask some good questions, but I think that I would like to try and focus us back, if I might, to part of my testimony. If you look at the investing we do at the TSP, one could always point out there are many sectors, very narrow sectors of investment vehicles that could always return, at different periods of time, higher results than broad-based indexes. There is no question about that. You could pick it out. I think a perfect example which we all hear about all the time is hedge funds. If you look at the good hedge fund operators, they have certainly done better than the broad-based indexes. You could point to——

Ms. NORTON. It is not fair to choose the worst examples.

Mr. SAUL. Well, I think they are very good examples. There is over $1 trillion invested in hedge funds——

Ms. NORTON. Are you invested at all in hedge funds? Are we invested?

Mr. SAUL. Personally, I have a lot of investment in hedge funds.

Ms. NORTON. No, you and me, sir.

Mr. SAUL. But I wouldn't recommend it for this plan. That is my point. I think that what you have to look at here is this is a broad-

based plan of indexes that I think gives a highly diversified portfolio of availability to the participants, everything from money markets to international stocks. Yes, there are segments—and, by the way, all these different things are covered, for the most part, in these different index funds, all different kinds of investments. Energy stocks, you could pick out energy stocks in the last have been the greatest investment since Swiss cheese.

But I guarantee you, and I don't have the numbers right here, but if you look at the TSP, it is very heavily weighted as the U.S. economy is weighted in energy stocks. The indexes are weighted to REITs as the U.S. economy as the indexes are weighted. And I think the important thing is to focus on what the TSP—and this is as a fiduciary I am talking about now—is to be able to offer a diversified portfolio that is easy to understand, relatively simple to operate to the investing participants.

Ms. NORTON. Mr. Chairman, I have finished my questions. I just want to leave you with what I hope your study shows me. Your off-the-chart examples—hedge funds, energy—do not respond to the chairman's example of the long-term returns on REITs. That is No. 1. No. 2, you told me something that impressed me. You said you were already diversified within the funds we had. That impressed me.

Then I thought about REITs, the short-term and the long-term return on REITs, and all I could think of, well, if they were diversified in REITs, really diversified within their present funds, sufficiently in REITs-type investments, then their fund, TSP, would have done better between 2000 and 2003.

Look, I am with you. I am with you only because you do this every day, you have a unanimous Board. I am not about to second-guess; you know, I did my second-guessing during dot com. I am not about to second-guess your judgment. I do want to say you have not—I have a presumption in favor of what you have said, but that presumption fell. That presumption has fallen. If you could have shown me that you had done pretty well during a good period that I think testified what happens to funds that were adequately diversified, then it seems to me I would have another view.

I have not yet come to the conclusion that we should invest in REITs, but I do need to know why, particularly since you were willing to take the transaction costs in 1996 and have two more funds, I do want to know, in the long-run, after your review of all the possibilities—and, as I understand, you will be looking not only at REITs, but whether or not you should be in some other things as well. That is very fair. That is very fair.

But given what the long-term returns shown on REITs, given your meager investment in REITs, then it seems to me you have an obligation either to show us that we ought to be in REITs or you ought to be more in REITs in terms of your own diversification.

Thank you, Mr. Chairman.

Mr. PORTER. Thank you.

Mr. Van Hollen.

Mr. VAN HOLLEN. Thank you, Mr. Chairman.

And thank both of you gentlemen for your testimony. I understand your caution on adding a REIT option, and I appreciate your caution. In my view, you have an institutional responsibility to ex-

ercise an overabundance of caution and take a very careful look at any additional options that are added to the plan.

But I also think we all have the same goal in mind: we want to make sure that Federal employees have a source for stable and reliable retirement income and that they have the opportunity to take advantage of all the options that are out there, including options that are increasingly available in the private sector.

Now, your testimony was that you have about $1 billion invested in REITs, which is a lot of money in an absolute sense, but as a percentage of your overall portfolio, as Congresswoman Norton's questions pointed out, it really is small. As a percentage, what is it, about 0.7 percent?

Mr. AMELIO. Eight percent, 8.3, I think.

Mr. VAN HOLLEN. I am sorry?

Mr. AMELIO. It is a little over 8 percent.

Mr. VAN HOLLEN. Eight percent of your portfolio is invested in REITs?

Mr. AMELIO. Yes.

Mr. VAN HOLLEN. All right.

Mr. AMELIO. And that is a significant number by all industry weightings.

Mr. VAN HOLLEN. All right. That information is somewhat at odds with other information we have gotten, so that is something we can flush out. One of the purposes——

Mr. PORTER. Would the gentleman yield?

Mr. VAN HOLLEN. I would be happy to yield.

Mr. PORTER. You have $155 billion, correct, in assets? It appears to me that $1 billion of $155 is less than 1 percent.

Mr. AMELIO. Oh, I am sorry, it is 8 percent of the S Fund.

Mr. VAN HOLLEN. Oh, OK. Well, that is a very different answer.

Mr. PORTER. One percent.

Mr. SAUL. But you have to take out the Money Market Fund, you have to take out the debt funds, because that really has no bearing on any equity at all. Don't forget, 47 or 46 percent of the Fund is invested either in the Money Market Fund or the Lehman Brothers Bond Index Fund. So you have to really take the debt out. So really what you have left is the equity portion and the debt portion; you can't talk about it together.

Mr. VAN HOLLEN. OK.

Mr. SAUL. People have made that choice.

Mr. VAN HOLLEN. OK. But in terms of the overall Fund, it is a little less than 1 percent. But I understand the points that you are raising.

Let me ask you. In the State of Maryland we have an Employee Retirement Fund where I think that we have a considerable greater amount invested in real estate options, including the REIT option, and you raised the question about the demand from people who are participating in the system for this option. I haven't heard a huge demand, but I have heard constituents of mine who say they wish they had an opportunity to invest in a REIT option and that it would provide an additional investment opportunity.

And, of course, in the final analysis it would be their choice. In other words, if people are not interested, I think that would be reflected in the demand for investment in this fund. So I think that

issue cuts both ways, and ultimately it will be the decision for people who are making this investment.

So, Mr. Chairman, I don't have a lot of questions on this. I would like to get more testimony on the cost issues you raised with respect to the transaction costs. And one of the reasons I think it is very important that we are going forward on this hearing and pushing on this is to get out in the open, as part of a public dialog, some of these issues.

But I guess in closing I would ask you this, because it is my understanding that within the private sector there are a growing number of 401(k) plans offered in the private sector that offer a REIT-specific investment option, that it is an upward trend in the private sector. Is that your understanding?

Mr. AMELIO. Yes. I wouldn't argue with that.

Mr. VAN HOLLEN. And I also understand that four of the six largest 401(k) plans in the private sector now offer their participants a REIT option. Do you know whether or not that is the case?

Mr. AMELIO. Actually, I believe that might be erroneous, but I could be wrong. The last thing I saw did not show that, but I could be wrong about that.

Mr. VAN HOLLEN. But I guess the point here is that my constituents who are working the private sector and working for different companies increasingly have an opportunity within their savings options to invest in REIT funds, specific REIT funds, and the question is why shouldn't we offer Federal employees the same option that is increasingly being offered to individuals in the private sector? I guess I would ask you that question.

Mr. AMELIO. I want to make a point. If you look at percentages, we are off the charts. We have 87 percent participation amongst people eligible to participate in the TSP. If you look at the private sector, it is about 70 percent. So we have a higher confidence level in our participants. And from the participants that we have talked to and from all of the experts that have written about it, it is because of the simplicity; there are five funds only.

And that really has a lot to do with it, it is simplicity. Major studies by major vendors in the industry have shown that for every 10 investment options that you offer, you lose 2 percent of the participants; they throw their hands up and walk away. They get overwhelmed, they get confused; they don't want to deal with it. So it is just innate, very protective, and I would argue not conservative. I don't think we manage the plan conservatively; we try to be protective of it. But you don't want to drive participants away by adding a lot of funds. You are talking about one here.

My biggest concern, and I think one of the Congress people mentioned before, is process. This is a very bad way to add a fund, to do a onesy, to look at one fund and say we have to add this one fund. If you go out and talk to the fiduciary of every major private sector plan in America, they will tell you they get a consultant and they look at the universe; what is in the plan, what is out of the plan, and let us figure how to fill in the gaps, get out of funds that aren't being used, and what to add. Nobody that I am aware of, no major fiduciary just simply says one off, let us just throw one fund into this.

And even looking at the long-term numbers, I don't see where they differ between the REITs and the C and S from 1988 back to technically when the plan was brought in; they are virtually the same.

The REIT Fund here, the numbers that Congresswoman Norton was talking about, the REIT, 14 percent. The S Fund is 13.8 and the C Fund is 13.7. I mean, it is de minimis. We had the same yields in two of the funds. Certainly the G Fund is lower, but at 6.6, that is bigger than any money market or savings fund. We are very competitive.

Remember with the indexes. When Congress established this plan in 1986, they wanted to take politics out of it. They don't want us to try and hire money managers to beat the markets. Only 15 percent beat the markets every year; 85 percent do worse than the markets. What Congress wanted originally, and it was ingenious, was take politics out of this and just have it stay with the markets, rather than trying to beat them, because most people don't on a regular basis.

Mr. SAUL. Mr. Chairman, may I just add something, because I think it is important, if I might? If you look at these records, we have here in front of us 1988 to 2004, which is 16 years of history here. And Gary has given you the statistics of 13.7 for the C Fund, 13.8 for the S Fund, 14 percent for the REIT Fund. That is what I was trying to refer to when I made my statement. I think I was answering a question that you asked, Mr. Chairman, about a long period of time.

Mr. PORTER. Excuse me, Mr. Saul. The point is that the REITs did very well, did better than any of your funds in that period of time. And you were commenting that over a long period of time the REITs were not a good investment, or not as good of an investment. In fact, they were better than the other funds.

Mr. SAUL. I am sorry, that is not what I meant. Anyway, what I tried to say is over a long period of time, 16 years, the C, S, and the REIT Fund were very close in performance. It is true, over a 4-year period, there is no question, because there was a downturn in the stock market, the C and S did not nearly perform as well as the REIT. There is no question.

But what I said was you have to look at this whole thing as a person's investment from when they basically begin investing, as a young person, until the time they get out of the plan, how they have done with these different investments.

Mr. PORTER. If I may interrupt, the bottom line is they would have been better off in a REIT than the G, the I, or the F in that period of time.

Mr. SAUL. Well, the G Fund is a Money Market Fund, basically all it is is treasuries, U.S. treasuries, so you have to take them out.

Mr. PORTER. Well, said, but if you are going to compare—so remove that. You were still better off in the REIT than the I and the F.

Mr. SAUL. Well, the F Fund you can't compare it because—let us look at these funds. The F Fund is a bond fund, it is a debt fund. Usually a bond fund has more stability, a debt fund, than an equity fund. You are getting a lower return, but you are taking less risk. So I think the F Fund you have to take out over a long period of

time, it is a bond fund. It is very heavy-weighted to U.S. Government bonds, which we hope are the safest thing. So that is 8 percent.

The G Fund is strictly a short-term Treasury operation where the participants get a 3 point spread over 90 day rate because of a long history that we have and so forth, so that——

Mr. PORTER. I don't think we disagree on that. But what I do disagree with is the fact that the REIT would not have been a good investment in this period of time. It would have been.

Mr. SAUL. Nobody is saying it wouldn't have been. But that was—we are not arguing against REITs. That is my point. I tried to say that when Congresswoman Norton asked her very important question, I thought, before. We are not arguing against REITs. What we are arguing for is the simplicity of the plan for unsophisticated investors. We have——

Mr. PORTER. Mr. Saul, I am sorry to interrupt again. That is probably the fourth time I have heard about unsophisticated investors, and I do take exception to that. I do believe that there are folks that, as you said, have high confidence in what you are providing for them as options. But, please, that is probably the fourth time I have heard unsophisticated. I give them higher regard than that. I think there are many that want as easy a system as possible, but there are also those that would like to choose other options.

Mr. SAUL. When I said unsophisticated, I thought I explained that in my testimony before. When I meant unsophisticated, I didn't mean unsophisticated individuals, I meant unsophisticated in financial investing. One could be a very sophisticated person, for example, a man that is a captain of a U.S. submarine could be a very sophisticated person, but may not be a sophisticated financial investor. That is what I meant.

Mr. PORTER. Which is why we want to diversify in as many options as possible, correct?

Mr. SAUL. That is what I thought we have done.

Mr. PORTER. Thank you. Appreciate your testimony.

I would like to now move on to the third panel.

We appreciate the gentlemen being here. Thank you again, Mr. Saul and Mr. Amelio.

Welcome. We appreciate your being here today. This being our third panel, I would like to introduce Mr. Steven Wechsler, president and CEO of the National Association of Real Estate Investment Trusts. We will then hear—and I guess Dr. Ibbotson?

Mr. IBBOTSON. Ibbotson, yes.

Mr. PORTER. You are not here to testify, but to answer questions, is that correct, or do you have a prepared statement?

Mr. IBBOTSON. I did submit a white paper, but I am not going to read that to you.

Mr. PORTER. Fine. No problem. Thank you very much.

Mr. IBBOTSON. I will maybe refer to it.

Mr. PORTER. And then we will have Ms. Amy Schioldager, head of the U.S. indexing products at Barclays Global Investors.

I would like to begin. Mr. Wechsler, you have 5 minutes.

STATEMENTS OF STEVEN WECHSLER, PRESIDENT AND CEO, NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS; DR. ROGER IBBOTSON, CHAIRMAN, IBBOTSON ASSOCIATES, PROFESSOR OF FINANCE, YALE UNIVERSITY; AND AMY SCHIOLDAGER, MANAGING DIRECTOR, HEAD OF U.S. INDEXING PRODUCTS, BARCLAYS GLOBAL INVESTORS

STATEMENT OF STEVEN WECHSLER

Mr. WECHSLER. Good afternoon, Mr. Chairman, Mr. Davis, members of the subcommittee. I am Steve Wechsler, president and CEO of the National Association of Real Estate Investment Trusts. NAREIT represents U.S. Real Estate Investment Trusts [REITs], and publicly traded real estate companies worldwide.

I want to preface my remarks by complimenting Congress and the Federal Retirement Thrift Investment Board for providing through the Thrift Savings Plan a well conceived base model for defined contribution plans. The plan offers a set of core investment choices utilizing low-cost index funds that maximize return to participants.

I would also like to compliment Chairman Saul, the other Board members, and TSP staff for keeping pace with the private sector by soon providing plan participants with a set of Lifecycle Funds.

Today's hearing is styled "Real Estate Investment Trusts: Can They Improve the Thrift Savings Plan?" Based on detailed analysis, rigorous research, and historical experience, we believe the answer is an unqualified yes.

Investment research demonstrates that the plan can be further improved and the retirement benefits enhanced by adding low-cost additional asset choices with long-term investment performance and diversification benefits. One such core asset or distinct investment choice is commercial real estate. For decades, traditional pension plans, also known as defined benefit plans, as well as endowments in foundations have included a distinct allocation to commercial real estate in their investment portfolios.

For example, the Nation's largest corporate defined benefit plan, that of General Motors, reported a real estate allocation of 8 percent; the Nation's largest public defined benefit plan, California's CalPERS, reported a real estate allocation of 7.5 percent; and Harvard University, the Nation's largest endowment, had a real estate allocation of 10 percent.

The concept of including real estate as a distinct investment choice in a retirement plan is neither new, nor untested. Congress understood the importance of commercial real estate investment for investors large and small when it created REITs. Today, the time has come to extend that vision to 3.4 million small investors who participate in the TSP by including a distinct REIT-based real estate option.

Our Nation's publicly traded equity REITs are companies that generally own, rent, and manage portfolios of investment-grade, income-producing commercial real estate, including office buildings, distribution facilities, shopping centers, and apartments. Because REITs must distribute their taxable income to shareholders, their dividend yields are significantly higher than those of other equities,

three times higher than those in the S&P 500, and produce a steady stream of growing income.

REIT stock returns combine the growth characteristics of other stocks and the income characteristics of bonds. When the dividend income and price appreciation are combined, the 14 percent average annual total return to REIT stocks from 1988, the year the TSP began full operation, through 2004 was appreciably higher than comparable returns to bonds and above the returns to other large and small-cap stocks. Returns to REIT stocks during that period have come with a level of volatility, a common measure of risk, which has been below that of other large and small-cap stocks.

Strong returns, low volatility, and a low correlation with the returns to other assets are key ingredients to meaningful investment portfolio diversification, an accepted strategy for reducing investment risk. Research has demonstrated that investment returns from commercial real estate are different than returns from other investments. Studies also have concluded that the competitive returns, low volatility, and low correlation of investment returns from REITs make them a powerful diversification tool.

So it is not surprising that the proportion of 401(k) plans nationwide offering a real estate fund is on the rise. In fact, four of the six largest 401(k) plans in the private sector now offer a real estate fund option.

In a study requested by NAREIT, Ibbotson Associates, an authority on asset allocation, found that a distinct REIT index fund increases returns and reduces risk when added to efficient portfolios of the existing five TSP funds. Given that the TSP to date only offers five choices, versus an average of 16 for the Nation's typical 401(k) plan, it is clear that Federal workers are far too limited in their choices. Consequently, NAREIT believes that the TSP can be improved materially by adding more investment choices, starting with a REIT-based real estate option.

For the foregoing reasons, NAREIT strongly supports H.R. 1578, the Real Estate Investment Thrift Savings Act, and commends its sponsors, especially Chairman Porter, Mr. Van Hollen, and Chairman Davis for introducing this significant legislation. It would give Federal workers the choice in their retirement savings program, which is supplemental to a Federal pension and Social Security, to specifically seize for themselves the real estate investment opportunity Congress created for small investors years ago.

As I close, Mr. Chairman, I want to underline that NAREIT does not maintain that a REIT-based real estate option is the only additional option which should be considered over time for inclusion in the plan, but it is sure a good place to start.

I would be pleased to answer any questions, but I leave you with a question for Congress and the Board to ponder further. Why shouldn't the men and women who work for our Nation have access to the range of retirement savings choices currently available to employees of many leading private sector firms and to large institutions saving and investing on behalf of their workers?

Thank you.

[The prepared statement of Mr. Wechsler follows:]

Statement of

Steven A. Wechsler

On Behalf of the

National Association of Real Estate Investment Trusts®

Before the

Committee on Government Reform's
Subcommittee on the Federal Workforce and Agency Organization

U.S. House of Representatives

Hearing on H.R. 1578

Real Estate Investment Trusts (REITs):
Can They Improve the Thrift Savings Plan?

April 19, 2005

Statement submitted to the Subcommittee on the Federal Workforce and Agency Organization on April 19, 2005, pursuant to a hearing on H.R. 1578, the Real Estate Investment Thrift Savings Act.

My name is Steven A. Wechsler and I am President and CEO of the National Association of Real Estate Investment Trusts. NAREIT is the representative voice for real estate investment trusts (REITs) and publicly traded real estate companies worldwide. Thank you for the opportunity to testify on this matter of importance to the entire federal civilian and military workforce. To begin, NAREIT expresses its strong support for H.R. 1578, the Real Estate Investment Thrift Savings Act, and thanks all its sponsors, especially Chairman Porter, Mr. Van Hollen and Chairman Davis.

The Federal Thrift Savings Plan

The Federal Thrift Savings Plan for federal employees is the largest defined contribution plan in the country, with total assets of approximately $152 billion as of December 31, 2004. Congress designed the Thrift Savings Plan to provide federal civilian and military employees with an opportunity for retirement and tax-deferred savings similar to those private corporations and other organizations that offer their employees under 401(k), 403(b) and other such plans.

Since 1988, the Congress, the Federal Retirement Thrift Investment Board (Board) and the Thrift Savings Plan (TSP) staff have developed, refined and maintained an excellent base model for well-conceived defined contribution plans. The plan provides participants with a well-focused set of core investment choices utilizing low-cost index funds that minimize expenses and maximize returns to the participants.

In recent years, Congress and the Board also have initiated a series of innovative actions that have appreciably enhanced the TSP savings program for its participants and that will continue doing so for many years to come. Introducing the S Fund (small capitalization stocks) and the I Fund (international stocks) in 2001 provided plan participants the opportunity to further diversify their investments into two widely recognized core assets. And sometime this year the Board, under the leadership of Chairman Saul, will provide plan participants with access to a new set of life cycle funds, a wise decision that recognizes the pace of ongoing developments in the private sector.

It is important to recognize that three separate programs comprise the platform on which federal employees may build for their future financial and retirement security. The first two of these three programs provide defined benefits with minimal risk and include a traditional defined benefit annuity and a supplemental defined benefit annuity from social security. The Thrift Savings Plan provides a second supplemental savings program that offers plan participants the opportunity to earn higher returns commensurate with higher risk. In this light, it is appropriate that TSP participants are offered an appropriate selection of investment opportunities that provide access to a reasonable spectrum of risk and return tradeoffs.

Responding to a New Investment Landscape

Looking ahead, all small investors will face new challenges on the investment landscape. Today, everyone saving for retirement must address the future outlook for investment returns, in part by seeking new portfolio diversification opportunities. And while the private sector shifts ever further away from traditional pension plans and their guaranteed benefits to defined contribution plans, such as 401(k) plans, individual investors are accepting a growing responsibility for managing their financial future.

As this shift occurs, important opportunities to increase returns on retirement savings and to more effectively reduce the risk of those investments remain available to all individual savers, including TPS participants. However, those opportunities are available to participants only if they are provided with the tools to access those opportunities and only if they are given the choice. Investment research demonstrates that the TSP can be further improved, and the retirement benefits to federal workers appreciably enhanced, by adding one or more low-cost, core or distinct assets with proven long-term investment performance and diversification benefits. To effectively utilize new and existing investment options, plan participants also require appropriate education and guidance in choosing among these options.

One such proven asset is commercial real estate investment.

Real Estate as a Core Asset

For decades, traditional pension plans, also known as defined benefit plans, as well as major endowments and foundations, have included an allocation to commercial real estate in their investment portfolios. For example, the nation's largest corporate defined benefit plan – that of General Motors, with $87 billion in assets – reported a real estate allocation of 8.0 percent as of September 30, 2004. At the same time, the nation's largest public defined benefit plan – that of the California Public Employees Retirement System, with $168 billion in assets – reported a real estate allocation of 7.5 percent. And the nation's largest endowment – that of Harvard University, with about $20 billion in assets – reported a real estate allocation of 10 percent at last report.

The professionally trained investors managing these plans recognize the long-term performance attributes of commercial real estate investment, including consistent, long-term returns, low volatility, reliable dividend income, capital preservation and critical diversification benefits. And while direct property investment at large institutional investors often accounts for the larger share of their real estate allocations, a growing number of institutions in recent years have chosen to include real estate investment trusts (REITs) as part or all of their real estate allocation. In addition to the investment attributes of real estate, these investors are attracted to the liquidity, transparency,

accountability and management experience of publicly traded real estate companies or REITs.[1]

According to the 2004 Plan Sponsor Survey published by *Pensions & Investments* magazine, the Nevada Public Employees Retirement System reported a real estate allocation of 8.7 percent as of September 30, 2004, with REITs accounting for one-third of that allocation. Likewise, the Maryland State Retirement & Pension System reported a 6.6 percent allocation to real estate, with REITs accounting for nearly 60 percent of that allocation. And in looking at public defined benefit plans in the states of all members of the Subcommittee, we found that they have a combined real estate allocation of about 5 percent, and that 14 percent of the real estate allocation is invested in REITs.

So the concept of including real estate in a retirement plan is neither new nor untested. The professionals charged with the fiduciary duty for managing these plans recognize the importance of maintaining a distinct and continuing allocation to real estate in the investment profiles of their long-term defined benefit plans.

Fortunately, Congress also wisely recognized the importance of commercial real estate investment for small investors, as well as professional investors investing in behalf of small savers (including those saving for retirement), when it created REITs 45 years ago. As the Committee Report in 1960 noted, Congress created REITs so "small investors can secure advantages normally available only to those with large resources."

Today, the time has come to extend that vision to the millions of small investors building their financial security through the Thrift Savings Plan.

Real Estate Investment Trusts

REITs are publicly traded companies that own and, in most cases, manage portfolios of investment-grade, income-producing commercial real estate, including office buildings, warehouse and distribution facilities, retail centers, apartment communities and hotels.[2] REITs are not mutual funds, closed-end funds or partnerships.

REITs operate like other publicly traded companies, including familiar names like Microsoft, Verizon or Citigroup. However, unlike Microsoft (which designs and provides software), Verizon (which builds and provides telecommunications services) or Citigroup (which manages and provides financial services), REITs create and provide real estate services. REITs provide a simple and inexpensive way for all investors to invest in commercial real estate without buying property directly.

Today, there are nearly 200 publicly traded REITs that operate around the country. They own a combined portfolio of about $400 billion of commercial properties or

[1] In 2004, Institutional Shareholder Services rated the REIT industry first in its corporate governance rankings.
[2] Some REITs also provide financing for commercial real estate.

approximately 15-20 percent of all institutionally-owned commercial properties nationwide. Like the stocks of all other publicly traded companies, REIT stocks are bought and sold daily both by institutions and by individuals on the New York Stock Exchange, the American Stock Exchange and the NASDAQ. There are no restrictions and no penalties on such purchases and sales other than the normal brokerage fees paid to trade all securities on public markets. Trading volume of the companies comprising the NAREIT Equity REIT Index has grown appreciably in recent years. Daily dollar trading volume, a common measure of liquidity, now regularly exceeds $1 billion, with significantly higher volumes available when the market demands it.

Our analysis of the REIT marketplace shows that most REIT performance benchmarks have liquidity characteristics similar to those of the small-capitalization equity market in which the TSP's current Dow Jones Wilshire 4500 Completion Index (S fund) invests. The Board has established procedures that have cost-effectively managed cash flows in this market since the S fund was added to the plan in 2001. Assuming that one or more liquid REIT indexes are selected benchmarks for a REIT index fund, we believe that these same procedures would work just as effectively.

The common stocks of equity REITs – those REITs that specifically own and operate commercial properties – may be viewed as hybrid investments, combining the growth characteristics of other stocks and the income characteristics of bonds. The income component of the total return to REIT stocks comes from the steady rents received from the REIT's customers (its tenants). In practice today, about 95% of the assets of equity REITs is commercial real estate. REITs derive a significant part of their value and most of their reliable income from rents. Because REITs are required by federal law to distribute at least 90 percent of their taxable income each year to their shareholders, their dividend yields are significantly higher than those of other equities – currently about three times higher than the average dividend yield of the 500 companies in the Standard & Poor's 500 Stock Index – and generally produce a steady stream of growing income. On average over time, shareholder dividends have accounted for about two-thirds of the total return to REIT stocks.

The growth component of the total return to REIT stocks is tied to the long-term economic growth of the nation. Commercial real estate houses our economy. It provides the space in which we conduct our business activities, including the places where we work (office buildings), where we shop (retail centers), where we process and coordinate the transportation of goods (warehouse and distribution facilities), where some of us live (apartments) and where we stay when we travel (hotels). As the economy, grows the demand for space increases and provides new opportunities for REITs to expand their real estate services.

This unique combination of income and growth has resulted in strong and consistent total returns to REITs over all investment horizons when compared with other widely recognized measures of market performance. As shown in Exhibit 1, the compound annual total return to equity REITs has outpaced the returns to most other major market

indexes over most investment horizons for the past 33 years, the period for which comparable data are available. For example, over the 33-year period 1972-2004 equity REIT stocks produced a 13.4 percent annual total return compared with an 11.4 percent annual total return for the S&P 500.

Moreover, these higher investment returns were produced with lower levels of volatility, a common measure of risk, than that observed with most other measures of stock market performance. As shown in Exhibit 2, the annualized volatility of monthly total returns to equity REITs has been markedly lower than the volatility of returns to most other major market indexes over most investment horizons. For example, total returns to equity REIT stocks recorded annualized volatility of 13.7 percent over the 33-year period 1972-2004 compared with 15.5 percent for the S&P 500.

Finally, the unique combination of income and growth in the total return to REIT stocks implies that REIT returns are influenced more by their stock-like component during some periods but more by their bond-like component during other periods. Thus, REIT returns follow their own path, never completely like bonds and never totally like other stocks. This critical attribute of REIT returns results in total returns to REIT stocks that are unlike (or uncorrelated with) the returns to other stocks and bonds and is the key ingredient providing investors with important diversification benefits.

As shown in Exhibit 3, the correlation coefficients of REIT returns with the returns to other major equity market indexes have declined steadily over the past 15 years and remain relatively low. That means that the returns to equity REIT stocks do not track too closely the returns to other stocks, thereby providing the benefit of diversification. Likewise, Exhibit 4 shows that the correlation coefficients of REIT returns with the returns to other major bond market indexes also have declined and remain near zero today, meaning that REIT stocks respond differently than bonds to economic and financial developments.

Diversification and the Thrift Savings Plan

Diversification is a time-honored strategy for managing investment risk. By investing in a portfolio of distinctly different assets with returns that do not move too closely together, long-term total portfolio returns can be increased and risk can be reduced. As a result, an increasing number of financial experts recommend that retirement savings be spread among more than a few types of investments.

However, to effectively build a well-diversified retirement portfolio, plan participants require an adequate number of investment funds from which to choose. While there appears to be no consensus regarding the optimum number or type of investment funds, available survey data reveal that there are approximately 16 investment funds on average available in defined contribution plans nationwide.[3] Considering that the TSP today

[3] See "47th Annual Survey of Profit Sharing and 401(k) plans: Reflecting 2003 Plan Year Experience," published by the Profit Sharing/401(k) Council of America.

offers its participants only 5 choices, it appears that federal civilian and military employees are among those most limited in their ability to assemble a truly diversified retirement portfolio.[4]

Over several decades, academic research has demonstrated that the returns available from commercial real estate investment are appreciably different than the returns from other investments, thereby offering significant diversification benefits. Likewise, more recent research has concluded that the relatively high returns, low volatility and low correlation of the investment returns from REITs makes REITs a powerful diversification tool for individual investors as well as large institutions.

Acknowledging the results of this research, IBM, sponsor of the nation's largest 401(k) plan with $23.4 billion of assets as of September 2004, added a REIT index fund as a distinct investment choice to its plan in 2004.[5] According to a story in *Pensions & Investments*, an IBM spokesperson reported that the new REIT index fund give its plan participants "the opportunity to invest in what we consider to be a separate asset class which increasingly seems to have a low correlation to other more traditional asset classes."[6]

In addition, Morningstar, Inc., a leading provider of independent investment research, includes REITs as a distinct investment in a model portfolio for retirees, with a recommended allocation of at least 5 percent.[7]

As those with fiduciary responsibilities for today's public and private defined contribution plans look to improve the performance and effectiveness of their plans, it is not surprising that the proportion of 401(k) plans nationwide offering a real estate fund to their plan participants is on the increase, rising from around five percent in the late 1990s to about 12 percent as of 2003. Today, four of the six largest 401(k) plans in the private sector now offer their participants a REIT option. And in light of these developments, it seems reasonable to ask why the employees of some of the largest private sector plans have the advantage of choosing a distinct REIT option, while TSP participants do not?

It is important to note that NAREIT does not suggest that REITs should be the only additional distinct investment option considered for inclusion in the Federal Thrift Savings Plan. As stated at the beginning, the Congress, the Board and the TSP staff together have crafted, refined and managed an admirable base supplemental retirement plan for federal employees. What we are suggesting, however, is that significant opportunity for improved diversification is still available, improvement that will benefit

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[4] In a November 2003 report available at www.psca.org, data from the "46th Annual Survey of Profit Sharing and 401(k) plans: Reflecting 2002 Plan Year Experience" were reported to show that plans offering lifestyle funds "tend to have more investment options than other plans, offering an average of 20 investment options for participant contributions, compared to only 14 options in plans that have no lifestyle funds."

[5] Barclays Global Investors, San Francisco, is manager of the IBM real estate investment trust index fund.

[6] *Pensions & Investments*, May 31, 2004.

[7] http://news.morningstar.com/doc/document/print/1,3651,103823,00.html

all TSP participants, including those that choose new life cycle funds as well as those that do not.

It is especially important to underline just how critical are the decisions of investors to allocate and diversify their investments across an appropriate and effective set of distinct assets, as well as the decisions of plan sponsors to make appropriate and effective investment choices available to their plan participants. In pioneering investment research that first appeared in 1986 and was subsequently updated in 1991, it was revealed that, on average, over 91 percent of the variation of portfolio returns can be explained by differences in the allocation of investments across different assets.[8] These widely accepted results underscore how critical it is to the success of any investment program, including the Thrift Savings Plan, that an adequate number of investment choices are made available to plan participants and that those choices provide access to an appropriate spectrum of investment classes.

The research invites all of us to question whether the 5 investment funds currently available to TSP participants provide sufficient choice that maximizes the portfolio diversification opportunities potentially available to TSP participants. Or, do significant diversification benefits remain available by adding 1 or more new investment funds to the current menu of G, F, C, S and I funds?

A review of the historical performance record helps shed some light on the answer to this question. Exhibit 5 compares the performance of the G, F, C, S and I funds along with the performance of a REIT index fund for the period 1988 – 2004, the period for which the Thrift Savings Plan has been in full operation.[9] The 17-year record shows that REIT stocks provided total returns comparable to the returns available from the C Fund and the S Fund but with somewhat lower volatility.

Exhibit 6 summarizes the correlation of REIT fund returns with returns to the other 5 TSP funds. Echoing the results displayed earlier in Exhibits 3 and 4, it is clear that REIT fund returns have exhibited relatively low correlation with returns to the other 3 equity funds (the C, S and I funds) and even less correlation with the 2 available bond funds (the G and F funds).

Finally, Exhibit 7 clearly illustrates how performance and diversification has been driven over the period 1988 – 2004 by the distinguishing investment performance attributes of the G, F, C, S, I and REIT funds. It is evident that returns to the C fund and the S fund move closely together over time. It is equally apparent that returns to the G fund and the F fund move rather closely together, although the higher volatility of returns to the F fund induces a relatively low correlation of the returns to these two funds. However, the

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[8] G.P. Brinson, L.R. Hood and G.L. Beebower, "Determinants of Portfolio Performance II: An Update," *Financial Analysts Journal,* May/June 1991.

[9] The S and I funds first became available in May 2001. Fund returns prior to that time are based on their underlying index returns net of expenses. The REIT Fund data are based on NAREIT's equity REIT index, net of expenses that were conservatively assumed at twice the level of the other TSP stock index funds.

sharpest impression is how distinctly different are returns to the I fund and the REIT fund. Returns to both funds bear little resemblance to each other or to the returns of any of the other investment funds.

The historical record paints an attractive picture for the inclusion of a REIT index fund in the Thrift Savings Plan. However, a complete answer to the question of whether additional diversification benefits are available through a REIT fund to TSP participants requires a more rigorous analysis. In a study requested by NAREIT, Ibbotson Associates – a leading authority on asset allocation – assessed carefully the additional diversification benefits that could be made available to TSP participants by adding a distinct REIT index fund to the current TSP investment menu of 5 stock and bond investment funds. Ibbotson determined that a REIT index fund increases returns and reduces risk when added to efficient portfolios of G, F, C, S and I funds. Ibbotson also concluded that efficient portfolios include an appreciable allocation to a REIT index fund across most levels of investor risk tolerance.

Ibbotson's analysis is based on mean-variance optimization first pioneered by Harry M. Markowitz. In 1990, Markowitz shared the Nobel Prize in Economics for his contributions to modern portfolio theory. In particular, Markowitz showed how to measure the risk of various investments and how to combine those investments in a diversified portfolio to earn the maximum return available for a given level of risk. As we have seen, each type of investment produces returns having a unique set of performance attributes: the rate of return, the volatility of returns and the correlation of returns with other investments. When the rate of return is sufficiently high, the volatility of returns sufficiently low and/or the pattern of returns sufficiently different, the investment can earn a place in an optimal portfolio.

Using mean-variance optimization, Ibbotson determined optimal portfolio allocations using the current investment funds available to TSP participants. Once these allocations were determined, Ibbotson then established the diversification benefits available from adding a REIT index fund as another investment choice for TSP participants. Exhibit 8 shows optimal allocations to the G, F, C, S and I funds over the period 1988 – 2004 that would have achieved the maximum annual portfolio return for each level of portfolio risk as measured by the standard deviation of annual returns. At low levels of acceptable risk, allocations to the G fund are dominant owing primarily to the low volatility (or risk) of G fund returns. As the level of acceptable risk becomes more moderate, allocations to the G fund are reduced and allocations to the F fund and the C fund are increased to benefit from the higher returns that become available at more moderate levels of acceptable risk. A uniformly small allocation is made to the S fund across most levels of acceptable risk. At the highest levels of acceptable risk, allocations to the S fund become dominant because of the higher returns that become available when higher levels of risk are accepted.

It is important to note that the investment allocations in Exhibit 8 should not be interpreted as recommended allocations but only as illustrative allocations pertaining to

different levels of acceptable risk. In particular, these allocations should be viewed only as allocations that modern portfolio theory has identified as the allocations that would have been optimal had the performance record of the G, F, C, S and I funds for the period 1988 – 2004 been known in advance. Moreover, when only 5 investment choices are available, it is not unlikely that outsized allocations may be identified for one or more of those funds. However, optimal portfolio allocations may still be viewed as providing broad guidance when determining appropriate relative allocations among available investments at different levels of risk tolerance.

Exhibit 9 shows optimal allocations to the G, F, C, S, I and REIT funds. At low levels of acceptable risk, allocations to the G fund remain dominant. As the level of acceptable risk again becomes more moderate, allocations to the G fund are reduced while a combination of allocations to the F fund, C fund and REIT fund rapidly increase, taking advantage of the higher returns available from these three funds at more moderate levels of acceptable risk. At higher levels of acceptable risk, allocations to the F and C funds give way to higher allocations to the R fund because the average return to the R fund is higher than the average returns to the F and C funds, and the volatility of returns (or risk) to the R fund is lower than the volatility of returns to the F and C funds (see Exhibit 5). Across all levels of acceptable risk, there are no meaningful allocations to either the S fund or the I fund.

Again, it is important to note that the investment allocations in Exhibit 9 should not be interpreted as recommended allocations but only as the allocations that modern portfolio theory has identified as the allocations that would have been optimal had the performance record of the G, F, C, S, I and REIT funds for the period 1988 – 2004 been known in advance.

Combining the results from Exhibits 8 and 9, Ibbotson then determined the degree to which investment performance would have been improved had a REIT fund been available to optimal TSP portfolios. In particular, Exhibit 10 shows the increase in annual returns that would have been earned by adding a REIT fund to optimal portfolios at different levels of acceptable risk for the period 1988 – 2004. At low levels of acceptable risk, annual returns would have increased in the range of 40-60 basis points. At more moderate levels of acceptable risk, returns would have increased in the range of 80-140 basis points, before narrowing again at even higher levels of acceptable risk.

These results are further translated into participant benefits in Exhibit 11, which compares annual returns and the growth of $10,000 invested in portfolios with and without a REIT allocation at different levels of acceptable portfolio risk. For example, Ibbotson's analysis demonstrates that $10,000 invested in a moderate risk portfolio of TSP funds in 1988 – not including a REIT index fund – would have grown to $54,958 by the end of 2004. However, that same $10,000 investment in a moderate risk portfolio that included a REIT option would have increased in value to $64,679, an investment improvement of 17.7 percent over the portfolio without a REIT allocation.

While useful and instructive, any inferences drawn from the investment results shown in Exhibits 8 – 11 should be prudently tempered. After all, we live in a dynamic economy with dynamic markets that confront all investors from time to time with new opportunities as well as new risks. Indeed, our future most assuredly will be different from our past.

Nevertheless, the performance record and the optimization results suggest a number of instructive conclusions. First, a REIT index fund provides unambiguous portfolio diversification benefits typical of commercial real estate investments. Second, a REIT index fund increases returns and reduces risk when added to an optimum portfolio of G, F, C, S and I funds. And third, optimum portfolios include an appreciable allocation to a REIT index fund across most level of acceptable portfolio.

Thus, even small allocations to a REIT index fund would provide appreciable diversification benefits to TSP participants. For example, Exhibit 12 illustrates the benefits derived in portfolios that include a 10 percent allocation to a REIT index fund. Even in these cases, the investment returns on each $10,000 invested are increased between 6 and 7 percent.

Today, the diversification benefits of REITs, as demonstrated by Ibbotson's analysis, are available to all investors, including TSP participants, but only if the specific opportunity is made available to them. As noted earlier, the employees, retirees and other beneficiaries at such diverse organizations as General Motors, Harvard University, California Public Employees Retirement System and IBM already have access to these diversification benefits. Why should the men and women who work daily for the benefit of the nation as a whole not have access to the same retirement savings opportunities? Why should federal workers not have specific access in their retirement savings program to the opportunities Congress intended for small investors 45 years ago?

Is Adding a REIT Index Fund to the TSP Feasible?

Apart from the investment merits and diversification benefits of adding a REIT index fund to the Thrift Savings Plan, the provisions of H.R. 1578 also raise a number of important questions tied to the operational and economic feasibility of adding a REIT index fund to the current TSP menu of 5 investment funds. In general, these questions have focused on:

- What would be the administrative and management costs?
- To what extent would there be duplication of existing investments?
- What is an appropriate performance benchmark?
- What if past performance is not indicative of future results?

Administrative and Management Costs

The Thrift Savings Plan now provides participants with a well-focused set of core investment choices utilizing low-cost index funds that minimize expenses and maximize returns to the participants. The Board and TSP staff have done a remarkable job of managing these costs and maintaining them at remarkably low levels. According to information published by the TSP, 2004 expense ratios, which include administrative costs plus investment management fees, were 6 basis points for the G, C, S and I funds and 5 basis points for the F fund.

Although the Board knows best whether the TSP's administrative expenses for administering a REIT index fund would be more or less than its costs of administering the G, F, C, S and I funds, we have no reason to believe that the costs for administering a REIT index fund would be materially different.

An accurate determination of the level of investment management fees required to offer a REIT index fund likely are most suitably determined in a competitive bidding process. Still, NAREIT put this question to the portfolio managers and senior investment professionals at institutional investment firms that manage some of the largest actively managed, as well as passively indexed, REIT funds. We specifically asked them for their indications of the likely investment management fees of providing a REIT index fund to TSP participants. Generally speaking, these investment professionals recognize the appreciable economies of scale available when managing large investment funds like the TSP, and they indicated that the costs of managing a REIT index fund should not be prohibitive when compared with the costs of managing the TSP's other 5 funds.

However, apart from the important goal of maintaining low costs, the critical question for TSP participants, as well as for other investors, should not focus narrowly on the costs associated with any particular investment opportunity, but rather more broadly on the diversification and investment performance benefits available from that investment opportunity relative to its costs. The Ibbotson Associates analysis demonstrates that a REIT index fund would have increased performance and reduced risk if it had been available to TSP participants for the period 1988 – 2004. Moreover, the analysis conservatively assumed annual expense ratios for a REIT index fund at twice the level of the expense ratios of the C fund over the entire period. Even so, the Ibbotson analysis demonstrated that inclusion of a REIT index fund in optimal portfolios would have increased annual returns in the range of 26-145 basis points across all levels of risk tolerance.

Clearly, the demonstrated historical performance of REITs, net of expenses, presents a compelling case when considering additional investment choices for TSP participants.

Duplication of Existing Investments

Both the C fund and the S fund track market indexes that include some REIT stocks. Thus, the question may be asked whether TSP participants already have available to them the option of investing in REITs through one or both of these funds. In that case, a

distinct REIT index fund might be unnecessary because it only would duplicate investment in REITs already available through the C and S funds.

It is important to note that the Ibbotson Associates analysis fully accounts for the exposure to REIT stocks already available to TSP participants through the C fund and the S fund. Any duplication is of no consequence for the historical analyses developed by Ibbotson, as all duplication is reflected in the performance record of these two funds.

As noted earlier, the Ibbotson Associates analysis, the Morningstar® retirement guide and major institutional portfolios, including the widely recognized Harvard Endowment, all include a targeted allocation of at least 5-10 percent to income producing real estate investment, including REITs, in order to achieve a meaningful and appropriate amount of portfolio diversification. In all these applications of modern portfolio theory, the critical issue is not whether the real estate allocation nominally is referred to as an "industry" allocation or an "asset class" allocation. Rather, the critical issue is whether a real estate allocation adds appreciable diversification benefits to the overall portfolio and what allocation is required in order to achieve those benefits.

The TSP's C fund tracks the Standard & Poor's 500 Stock Index, while the S fund tracks the Dow Jones Wilshire 4500 Completion Index. As shown in Exhibit 13, the S&P 500 Stock Index included 7 REIT stocks as of March 31, 2005. These 7 stocks combined had a market weight in the S&P 500 of 0.53 percent. The Dow Jones Wilshire 4500 Completion Index included 186 REITs with a combined market weight of 6.31 percent. Thus, some exposure to REIT stocks is embedded in the performance of the C and S funds. However, the exposure is very small and inadequate to obtain meaningful portfolio diversification.

In particular, a TSP participant either cannot obtain a meaningful REIT allocation by investing only in the C or S funds or can only achieve meaningful exposure to REITs by significantly concentrating his or her investments in one fund, the S fund, thereby violating a cardinal tenet of portfolio diversification. In the absence of a distinct REIT index fund, to obtain a 5 percent exposure to REITs, a TSP participant would need to invest approximately 80 percent of his or her total TSP account balance in the S fund. And a 10 percent allocation to REITs could not be achieved using any combination of current TSP investment funds.

Based on balances in the C fund and S fund as of December 31, 2004 and the market value of REIT stocks in these two funds as shown in Exhibit 13, we estimate that TSP participants on the whole have an implied allocation to REITs of approximately $1.0 billion, or less than 0.7 percent. As demonstrated by Ibbotson's analysis, such a limited allocation simply does not provide plan participants with a meaningful or beneficial exposure to commercial real estate, which can only be made available through a separate and distinct REIT index fund.

Choosing an Appropriate Performance Benchmark

In its analysis of the role and diversification benefits of a REIT index fund in TSP participant portfolios, Ibbotson Associates used the NAREIT Equity REIT Index, net of expenses, as a proxy for the investment returns that would have been available from such a fund. Calculated since 1972, the NAREIT Equity REIT Index is the longest available market benchmark for the performance of equity REITs. The index includes the common stocks of all publicly traded REITs, regardless of float and trading volume, including companies with large, mid-sized and small equity market capitalizations.

It is important to note that neither NAREIT nor Ibbotson Associates is recommending that the TSP introduce a REIT index fund using the NAREIT Equity REIT Index as its performance benchmark. Clearly, the choice of a performance benchmark for a REIT index fund would seem to be most appropriately determined by a qualified investment manager. Because the NAREIT Equity REIT Index is not an investable index today, the question may arise as to whether the index is a useful measure of the investment performance of investable REIT stocks as well as an appropriate measure for use in investment analysis.

To test the NAREIT Equity REIT Index as an appropriate performance benchmark for measuring "investable" REIT returns, Ibbotson Associates created an alternative benchmark that depends only on securities bought and sold on a daily basis by professional portfolio managers. The alternative benchmark consists of an equal-weighted portfolio of all available real estate mutual funds using data available from the Thomson Financial fund database for the period 1988 – 2004. Thus, the returns from a REIT index fund based on this alternative benchmark – the Real Estate Fund Benchmark – represent all REITs and real estate stocks actively bought and sold, with weightings averaged across those selected by all fund managers and expenses average across all investable funds.

According to the Ibbotson analysis, the compound annual return and standard deviation of annual returns of a REIT index fund based on the alternative Real Estate Fund Benchmark are nearly identical to those of a REIT index fund using the NAREIT Equity REIT Index. Thus, using the equal-weighted Real Estate Fund Benchmark to measure REIT returns results in optimal allocations to a REIT index fund that are very similar to those using the NAREIT Equity REIT Index. These results suggest that a REIT index fund, using returns measured by the NAREIT Equity REIT Index net of expenses, is a reasonable and appropriate proxy for average investable real estate fund returns actually available to investors over the period 1988 – 2004.[10]

[10] A variety of investable indexes should be considered as an appropriate performance benchmark for a REIT index fund. However, certain investable indexes, including the Dow Jones Wilshire Real Estate Securities Index, may not be appropriate indexes because they include a number of companies that are not equity REITs and exclude many companies that are REITs. Investability is a required but not necessarily a sufficient qualification for an appropriate REIT index fund benchmark.

Past Performance and Future Results

Underlying all investment research and analysis is one fundamental source of tension. The wisdom of today's investment decisions will be revealed by the performance of our chosen investments in the future, even though all of the information on which we base our decisions reflects the performance of those investments in the past. This underlying tension should rightly temper whatever inferences we draw from analyses based on historical information.

Ibbotson Associates and other research analysts address this tension with regularity. They recognize more than most that past performance is no guarantee of future results. In fact, their franchise and their reputation depend on an adequate understanding and recognition of this fundamental tension embedded in all investment research.

Ibbotson confronts this tension in a sensitivity analysis included in their most recent review of the performance and diversification benefits potentially available to TSP participants from the addition of a REIT index fund to the five funds currently available in the TSP. Because REIT returns combine attributes of the returns to both bonds and other stocks, Ibbotson's optimization results showed that increasing allocations to a REIT index fund reduced allocations to both other stock and bond funds for the period 1988 – 2004. But Ibbotson acknowledges that the performance of any asset class may be somewhat different in the future than it has been in the past, thereby changing the relative performance of different investments and possibly the optimal allocations to those investments.

Therefore, Ibbotson conducted a sensitivity analysis that considers the likely consequences to optimal portfolio allocations resulting from changes in the relative performance of a REIT index fund. However, rather than making arbitrary adjustments to the return, volatility and correlation of the REIT fund, Ibbotson chose to make such adjustments relative to the investment attributes of the C fund. Because REIT allocations in optimal portfolios in the Ibbotson analysis came largely at the expense of C fund allocations, the purpose of this approach was to determine what changes would be required in order for larger C fund allocations to reemerge.

The sensitivity analysis looks at the effects of four different types of changes to the relative investment performance of a REIT index fund:

- reducing REIT fund returns relative to the C fund, leaving volatility and correlations at historic levels;
- increasing REIT fund volatility relative to the C Fund, leaving returns and correlations at historic levels;
- increasing the correlation between the REIT fund and the C fund, leaving returns and volatility at historic levels;

- reducing REIT fund returns and volatility, leaving correlations at historic levels (*i.e.*, reducing REIT fund returns while maintaining a constant risk/reward tradeoff).

Results of the sensitivity analysis lead to the following conclusions:

- Reducing REIT fund returns results in larger allocations to the C fund for optimal portfolios with moderate to higher levels of risk, with some allocation to a REIT fund remaining appropriate until the S fund becomes dominant at the highest levels of acceptable risk.

- Increasing REIT fund volatility results in only slightly lower allocations to the REIT fund across most levels of acceptable risk.

- Increasing the correlation between a REIT index fund and C fund results in the S fund replacing the C fund as the only other equity investment in optimal portfolios, and the REIT fund remaining the dominant investment across most levels of risk tolerance.

- Maintaining a stable risk/reward tradeoff while reducing REIT fund returns and volatility is qualitatively similar to reducing REIT fund returns alone.

On balance, Ibbotson's sensitivity analysis demonstrates that the historical investment attributes of REITs make a REIT index fund an appropriate addition to a diversified portfolio of TSP equity and bond funds for a very wide range of investor risk tolerance. Moreover, the results also demonstrate that a REIT index fund remains firmly established in portfolios of TSP equity and bond funds even for a substantial range of unfavorable adjustments to the historical return, volatility and correlation of a REIT index fund.

Conclusion

In conclusion, the impressive long-term performance, reliable dividend income and proven diversification benefits of REITs demonstrate that any investor can use REIT stocks to build greater and more dependable long-term financial security. There is little doubt that the nation's 3.4 million TSP participants could also bolster their financial security by having the opportunity to include the dividends and diversification benefits of real estate stocks in a well-constructed retirement savings portfolio.

Exhibit 1

Historical Returns of Major Market Indexes

(Periods ended 2004:12)

Compound Annual Total Returns

(In percent)

Period Ended 31-Dec-04	S&P 500	Dow Jones	NASDAQ Composite	Russell 2000	MSCI EAFE	Lehman Brothers Bond	Equity REITs
1-Year	10.9	3.1	8.6	18.3	20.2	4.3	31.6
3-Year	3.6	2.5	3.7	11.5	11.9	6.2	23.3
5-Year	-2.3	-1.3	-11.8	6.6	-1.1	7.7	21.9
10-Year	12.1	10.9	11.2	11.5	5.6	7.7	14.8
15-Year	10.9	9.5	11.0	11.1	4.2	7.7	13.3
20-Year	13.2	11.5	11.5	11.5	11.4	8.8	12.7
25-Year	13.5	10.8	11.3	12.4	11.0	9.6	14.2
30-Year	13.7	10.0	12.7	NA	12.1	NA	16.2
33-Year	11.4	7.9	9.3	NA	10.6	NA	13.4
Risk[1]	17.7	16.5	27.6	19.1	22.4	7.5	17.0

[1] Standard deviation of annual returns for 1972-2004.

Source: NAREIT.

Exhibit 2
Volatility of Major Market Indexes
(Periods ended December 2004)

Annualized Volatility of Monthly Total Returns
(In percent)

Periods Ended 31-Dec-2004	S&P 500	Dow Jones	NASDAQ Composite	Russell 2000	MSCI EAFE	Lehman Brothers Bond	Equity REITs
1-Year	7.3	7.3	14.5	14.6	9.5	4.0	20.5
3-Year	15.1	15.1	22.2	19.2	15.7	4.3	14.6
5-Year	16.3	16.3	32.9	21.9	15.9	4.0	13.8
10-Year	15.6	15.9	28.9	19.9	15.1	3.8	13.0
15-Year	14.6	14.8	25.6	18.9	16.7	3.9	13.1
20-Year	15.5	15.7	24.2	19.3	17.4	4.5	12.5
25-Year	15.4	15.4	23.3	19.5	17.2	6.2	12.7
30-Year	15.2	15.5	22.4	NA	16.9	NA	13.1
33-Year	15.5	15.6	22.4	NA	17.0	NA	13.7

Source: Ibbotson Associates.

Exhibit 3

Correlation of Equity REIT Returns with Major Market Equity Returns

(Periods ended 1976:12 - 2004:12)

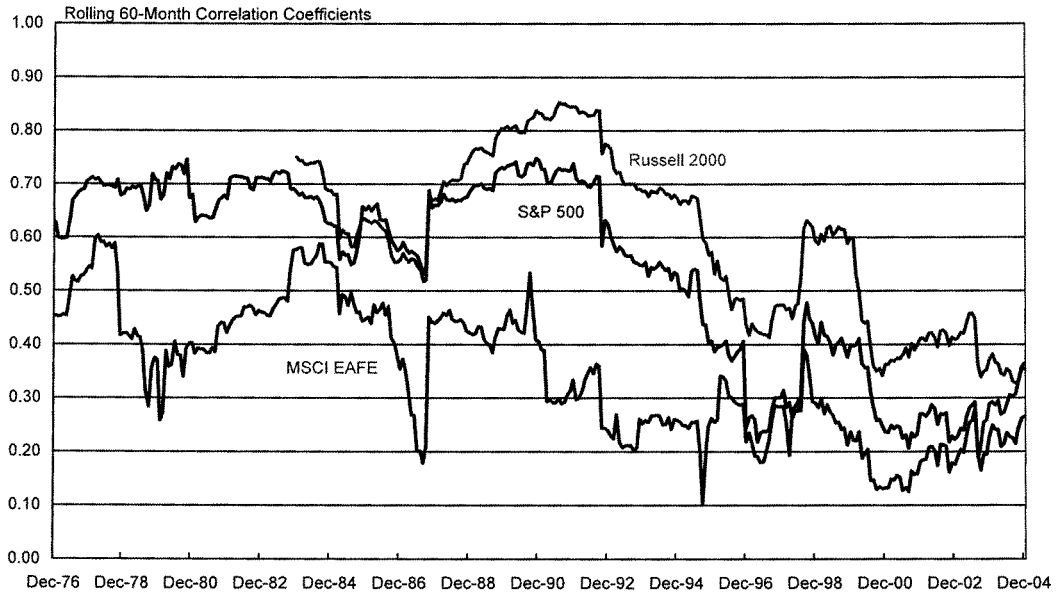
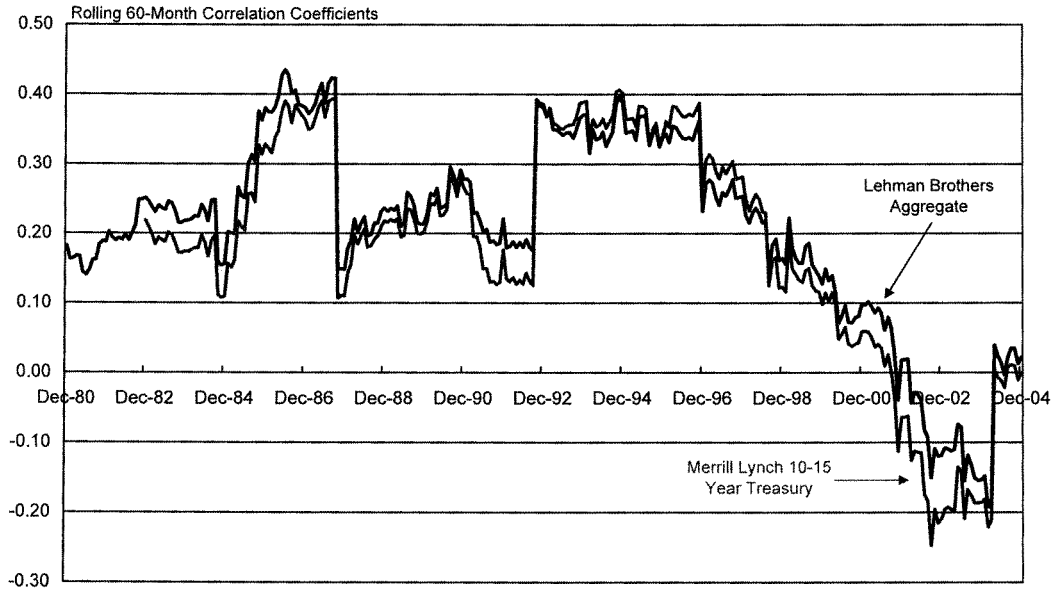


Exhibit 4

Correlation of Equity REIT Returns with Fixed Income Returns

(Periods ended 1976:12 - 2004:12)



Historical Security Returns.xls
Exhibit C.3

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Exhibit 5

Thrift Savings Plan Investment Fund Performance

(Current five funds plus REIT fund: 1988 - 2004)

	Average Annual Total Return (In percent)	Standard Deviation of Annual Total Returns (In percent)
G Fund	6.6	1.5
I Fund[1]	7.4	19.3
F Fund	8.1	5.4
C Fund	13.7	17.8
S Fund[1]	13.8	19.9
REIT Fund[2]	14.0	16.6

[1] S and I Fund returns before 2001 based on underlying index returns net of expenses.
[2] REIT Fund returns based on NAREIT Equity REIT Index net of expenses.
Source: Federal Retirement Thrift Investment Board, Ibbotson Associates.

Exhibit 6

Thrift Savings Plan Investment Fund Performance

(1988 - 2004)

Correlation Coefficients of Annual Total Returns

	G Fund	F Fund	C Fund	S Fund[1]	I Fund[1]	REIT Fund[2]
G Fund	1.00	0.29	0.20	0.03	-0.18	-0.24
F Fund		1.00	0.21	0.09	-0.21	0.14
C Fund			1.00	0.88	0.64	0.21
S Fund[1]				1.00	0.74	0.42
I Fund[1]					1.00	0.23
REIT Fund[2]						1.00

[1] S and I Fund returns before May 2001 based on underlying index returns net of expenses.

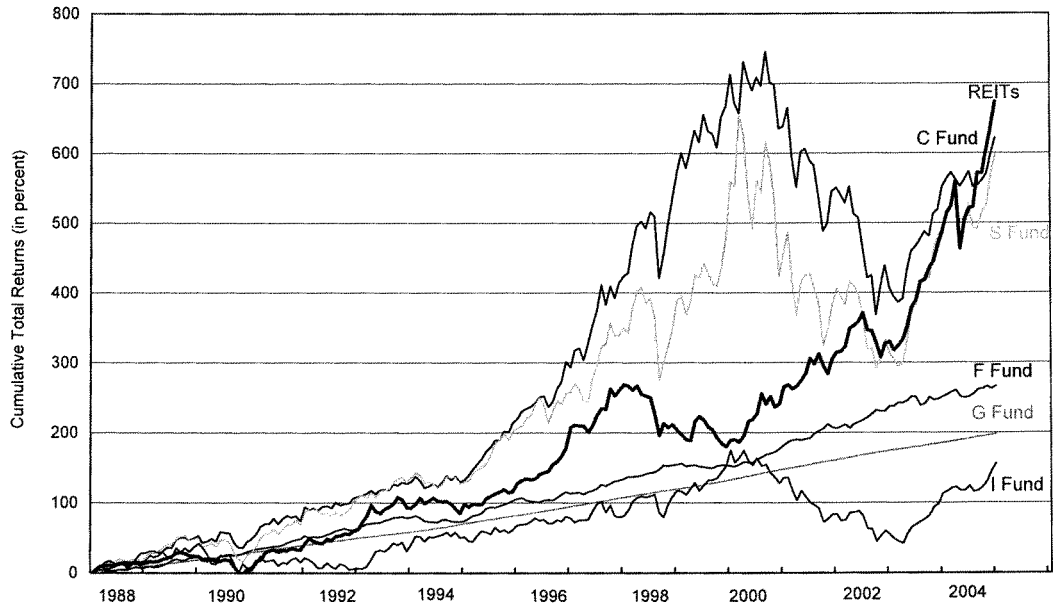
[2] REIT Fund returns based on NAREIT Equity REIT Index net of expenses.

Source: Federal Retirement Thrift Investment Board, Ibbotson Associates.

Exhibit 7

Thrift Savings Plan Cumulative Investment Fund Performance

Five current funds plus REITs: 1988 - 2004



FTSP Historical Data 2005.xls
Exhibit 7

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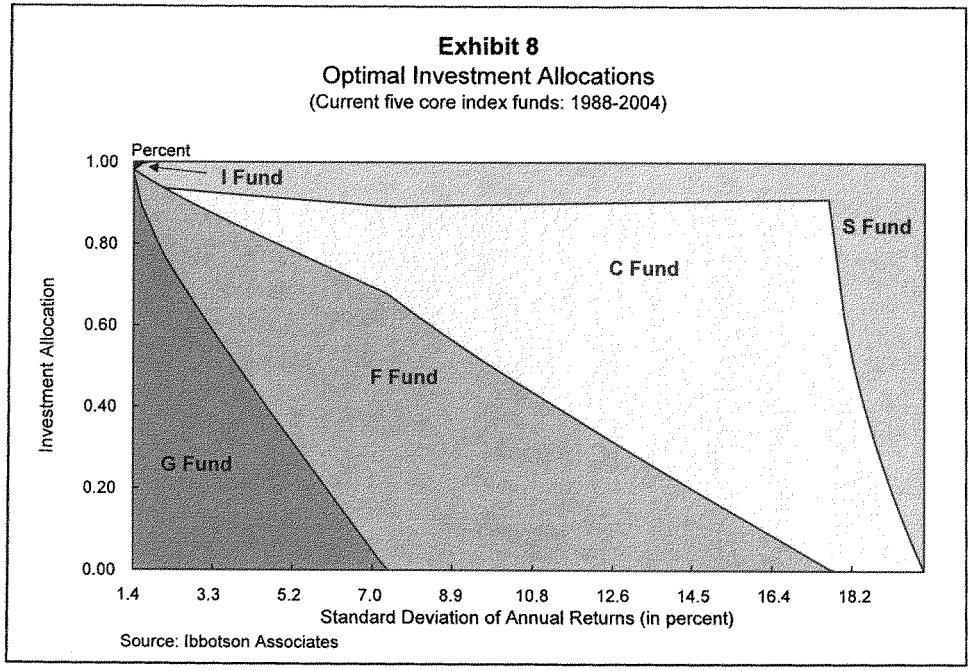
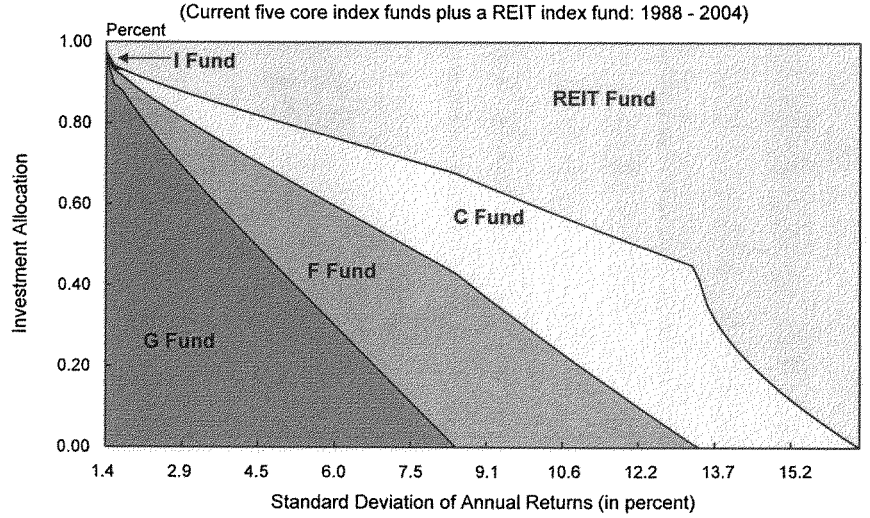


Exhibit 8
Optimal Investment Allocations
(Current five core index funds: 1988-2004)
Percent
1.00
0.80
0.60
0.40
0.20
0.00
Investment Allocation
I Fund
S Fund
C Fund
F Fund
G Fund
1.4
3.3
5.2
7.0
8.9
10.8
12.6
14.5
16.4
18.2
Standard Deviation of Annual Returns (in percent)
Source: Ibbotson Associates

Exhibit 9

Optimal Investment Allocations

(Current five core index funds plus a REIT index fund: 1988 - 2004)

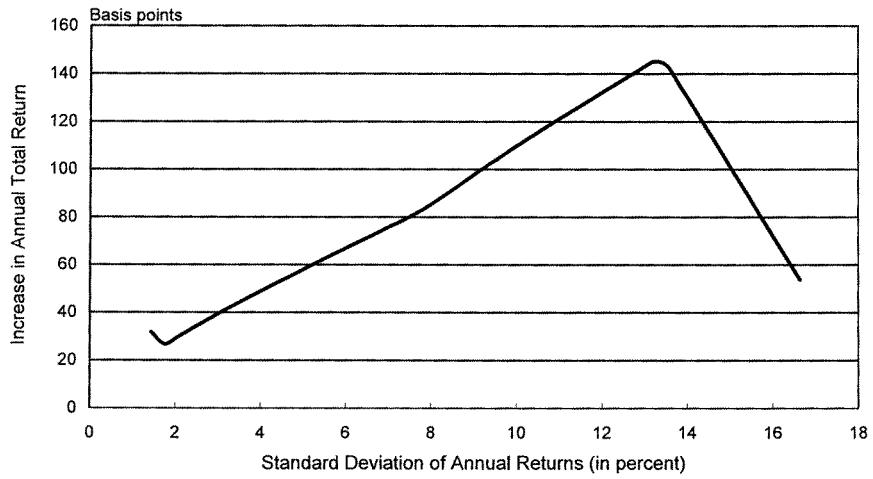


Source: Ibbotson Associates.

Exhibit 10

Annual Total Returns Increase when REIT Index Fund Added

(Current five core index funds plus a REIT index fund: 1988 - 2004)



Source: Ibbotson Associates.

Exhibit 11
Thrift Savings Plan Optimal Portfolio Performance
(1988-2004)

	Portfolio								
	1	2	3	4	5	6	7	8	9
				(Moderate risk portfolios)					
Expected Annual Returns (in percent)									
Without REITs	7.3	8.3	9.3	10.2	10.5	11.0	11.7	12.5	13.1
With REITs	7.6	8.8	10.0	11.1	11.6	12.3	13.2	13.9	13.9
Growth of $10,000 (in dollars)									
Without REITs	32,984	38,523	45,300	51,759	54,958	59,211	65,781	73,946	81,500
With REITs	34,680	41,790	50,801	59,740	64,679	71,452	82,203	91,444	92,019
(Percent increase)	5.1	8.5	12.1	15.4	17.7	20.7	25.0	23.7	12.9
Standard Deviation	2.0	4.0	6.0	8.0	9.0	10.0	12.0	14.0	16.0

Source: Ibbotson Associates

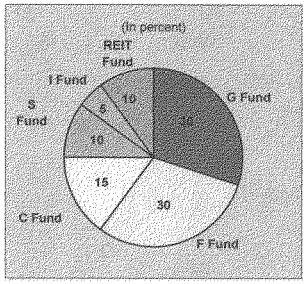
Exhibit 12

Growth of TSP Savings With and Without REITs

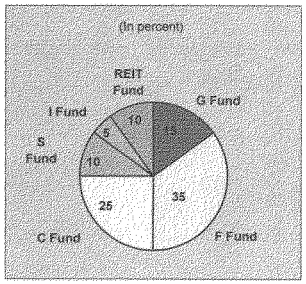
(Using actual returns for five current core index funds plus a REIT index fund: 1988 - 2004)

TSP Investment Allocations for Selected Levels of Portfolio Risk[1]

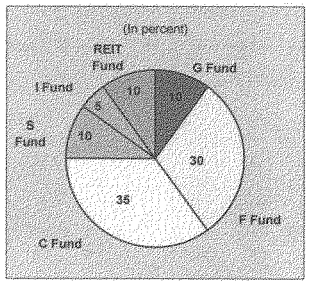
Below Moderate Risk



Moderate Risk



Above Moderate Risk



	Below Moderate Risk	Moderate Risk	Above Moderate Risk
Growth of $10,000			
Without REITs	$43,594	$48,278	$52,121
With REITs	$46,358	$51,460	$55,716
(Percent increase)	6.3	6.6	6.9

Source: Ibbotson Associates, NAREIT.

[1] Note: Investment allocations should not be interpreted as recommended allocations but only as allocations pertaining to different levels of risk.

Exhibit 13

Effective Investment Allocations to REITs Through Current TSP Equity Funds
(As of March 31, 2005)

REITs Represented in TSP Equity Funds	Number of REITs in Index	REIT Market Weight[1] (In percent)
C Fund (Standard & Poor's 500 Index)	7	0.53
S Fund (Dow Jones Wilshire Associates 4500 Completion Index)	186	6.31

Effective REIT Allocations When Investing in TSP Equity Funds

Hypothetical C Fund or S Fund Allocations in Percent	Effective REIT Allocations (In percent)	
	C Fund	S Fund
5	0.03	0.32
10	0.05	0.63
15	0.08	0.95
20	0.11	1.26
25	0.13	1.58
30	0.16	1.89
35	0.19	2.21
40	0.21	2.52
45	0.24	2.84
50	0.27	3.16
55	0.29	3.47
60	0.32	3.79
65	0.34	4.10
70	0.37	4.42
75	0.40	4.73
80	0.42	5.05

Sources: National Association of Real Estate Investment Trusts, Standard & Poor's, Wilshire Associates.
[1] Market weightings determined by equity market capitalization.

Mr. PORTER. Thank you for your testimony, we appreciate it.
Mr. Chairman will wait for questions.
[The prepared statement of Mr. Ibbotson follows:]

Participation of Roger G. Ibbotson
Chairman of the Board
Ibbotson Associates Inc.

Legislative Hearing of the House Subcommittee
on the Federal Workforce and Agency Organization

"Real Estate Investment Trusts (REITs):
Can They Improve the Thrift Savings Plan?"

April 19, 2005
Rayburn House Office Building
Room 2154

I. Introduction

Ibbotson Associates Inc., an investment research firm based in Chicago, Illinois, entered into an agreement with The National Association of Real Estate Investment Trusts® (NAREIT) to provide an updated presentation on the contribution of REIT stocks to portfolio performance for Federal Thrift Savings Plan beneficiaries. The study conducted by Ibbotson Associates sets out to assess what type of impact the addition of a REIT fund would have on historical portfolio performance when added to a portfolio comprised of the current five funds offered through the Federal Thrift Savings Plan. The goal was to determine if a REIT fund would offer participants of the Federal Thrift Savings Plan certain benefits not available through the plan's current investment options.

II. Executive Summary

- REITs have had higher historical returns over the period 1988 to 2004 compared to broad indexes of stocks and bonds.
- REITs provide excellent diversification benefits to stock and bond portfolios.
- A REIT fund would enhance the risk/return tradeoff of the G, F, C, S, and I Funds.

III. Federal Thrift Savings Plan Investment Funds

Three of the five current investment funds in the Federal Thrift Savings Plan contain total return data dating back to January 1988. These funds consist of the G Fund (government securities investment fund), F Fund (fixed income index investment fund), and C Fund (common stock index investment fund). This historical data was used throughout the presentation. Two of the remaining funds contain data dating back to May 2001. These funds consist of the S Fund (small capitalization stock index fund) and the I Fund (international stock index investment fund). In order to create the common starting date of January 1988 amongst all five funds, Ibbotson Associates backfilled the data of the S and I Funds using appropriate investment indexes as benchmarks. Since the objective of the S Fund is to match the performance of the Dow Jones Wilshire 4500 Index, a broad market index made up of stocks of U.S. companies not included in the S&P 500, Ibbotson utilized data on this index to backfill data to January 1988. The objective of the I Fund is to match the performance of the Morgan Stanley Capital International EAFE (Europe, Australasia, Far East) Index, a broad international market index, made up of stocks of companies in 21 developed countries. Ibbotson Associates utilized data on this index to backfill data for the I Fund to January 1988. For the period in which backfilled data was utilized, annual expense ratios were set equal to those of the C Fund. The R Fund (REIT fund) is represented by the NAREIT (The National Association of Real Estate Investment Trusts) Equity REIT Index. Annual expense ratios were calculated to be twice those of the C Fund's annual expense ratios.

Table 1 presents summary statistics of annual total returns for the five current investment funds as well as the R Fund. The summary statistics presented are geometric return (compound return), arithmetic return (average return), and standard deviation (risk). From the table it is quite apparent that the R Fund has provided the highest level of return among all of the funds presented over the period 1988 to 2004. In addition to offering a higher total return than the other stock funds, the C, S, and I Funds, it has done so with a lower standard deviation. Table 2 presents the annual cross-correlations for the five current investment funds as well as the R Fund. The cross-correlation between two funds measures the extent to which they move in relation to one another. Correlation coefficients range from negative 1 (as one fund moves in either direction, the fund that is perfectly negatively correlated will move by an equal amount in the opposite direction) to positive 1 (implies that as one fund moves, either up or down, the other fund will move in the same direction). Mean-variance optimization tends to favor investments with low to moderate correlation coefficients.

IV. Building Efficient Investment Portfolios

A majority of the analysis throughout the presentation is based on the concept of mean variance optimization pioneered by Harry M. Markowitz. Mean-variance optimization is the process of identifying portfolios, or groups of assets, that have the highest possible return for a given level of risk or the lowest possible risk for a given level of return. Such a portfolio is considered "efficient," and the locus of all efficient portfolios is called the efficient frontier. The historical investment period utilized in the analysis is from 1988 to 2004. Optimal portfolios using the current investment funds of the Federal Thrift Savings Plan were determined. Once this analysis had been conducted, diversification benefits of adding a REIT index fund were established.

Based on the fact that the Thrift Savings Plan is a long-term savings and investment plan designed to provide retirement income, maximizing investment performance is critical to achieving financial security for plan participants. Diversification of investments is central to the modern understanding of prudence in risk bearing and maximization of portfolio performance. Each type of asset produces investment returns having a unique set of investment attributes: rate of return, volatility of returns, and correlation of returns. When the rate of return is sufficiently high, the volatility of returns sufficiently low, and/or the pattern of returns sufficiently different, the investment can earn a place in the optimal portfolio.

V. Optimal Investment Allocations

Mean-variance optimization was employed to determine optimal portfolio allocations made up of the plan's five current investment options (G, F, C, S, and I Funds). Historical data for the period January 1988 to December 2004 was used in the optimization process (please refer to Tables 1 and 2 for a summary of the data used in the optimization process). An efficient frontier was created that consisted of 100 optimal portfolios that historically provided the highest expected return possible for their respective risk levels. Figure 1 graphically depicts the optimal investment allocations with the current five funds. At low levels of standard deviation, or risk,

portfolios favor the G Fund due primarily to its low level of risk. As the risk level increases, the G fund falls out of favor and is replaced by the F and C Funds, with a smaller percentage allocated to the S Fund. At the highest risk and return levels, portfolios are heavily weighted towards the S Fund due to its corresponding high level of risk and return.

Next, mean-variance optimization was employed to determine what percentage of the plan's five current investment options, as well as the R Fund, make up optimal portfolio allocations. Once again historical data for the period January 1988 to December 2004 was used in the optimization process (please refer to Tables 1 and 2 for a summary of the data used in the optimization process). An efficient frontier was created and Figure 2 graphically depicts the optimal investment allocations with the current five funds as well as the R Fund. At low levels of standard deviation, or risk, portfolios favor the G Fund due to the low level of risk associated with the fund. As the risk level increases, the G fund falls out of favor and is replaced by combinations of the F, C, and R Funds. At the highest risk and return levels, portfolios are heavily weighted towards the R Fund due to its corresponding high level of risk and return. The R Fund appears in all of the optimal portfolios created—from those with the lowest risk and return parameters to those with the highest, with the percentage allocated to the R Fund increasing as the level of risk and corresponding return increases.

REITs have historically provided portfolio diversification benefits typical of commercial real estate investments. REITs increase returns and reduce risk when added to an optimum portfolio of G, F, C, S, and I Funds. Optimum portfolios included an appreciable allocation to REIT stocks across most levels of portfolio risk. This is primarily due to the fact that the R Fund has provided a higher total return than the C, S, and I Funds and has done so with less risk. Also, the correlation between the R Fund and the C, S, and I Funds has been low to moderate. Please refer to Tables 1 and 2 for the actual figures.

VI. Alternative REIT Benchmark Analysis

As an additional basis for comparison with the original R Fund analysis, an alternative REIT benchmark was considered. We constructed an equal-weighted portfolio of all available real estate mutual funds, based on the Thomson Financial fund database for the period of the original analysis. In other words, a portfolio of all available underlying REITs and real estate stocks, with weightings averaged across those selected by all fund managers, and expenses averaged across all investable funds, was developed.

Table 3 presents summary statistics of annual total returns for the original R Fund as well as the alternative R Fund constructed in the aforementioned manner. The summary statistics presented are geometric return (compound return), arithmetic return (average return), and standard deviation (risk). As the table clearly illustrates, the risk and return of the alternative R Fund are almost identical to those of the original R Fund. Figure 3 graphically depicts the optimal investment allocations with the current five funds as well as the alternative R Fund. The graph illustrates results that are very similar to the results presented in Figure 2. This makes sense due to the similarity of risk and return attributes between the alternative and original R Funds. These results suggest that the original R Fund, represented by the NAREIT Equity REIT

Index, is a reasonable proxy for the average investable real estate fund actually available to investors over the time period analyzed.

VII. Sensitivity Analysis

In the original analysis a percentage of the R Fund is present in each optimal portfolio and becomes the dominant fund with increasing risk tolerance. The analysis was conducted based on historical data and it should not be assumed that the results will hold true going forward. The risk and return parameters of the R Fund, as well as its correlation with the other funds, will change. Since we do not know in which direction these changes will take place, we were motivated to conduct a sensitivity analysis.

The risk, return, and correlation of the R Fund were modified in a series of "what if" scenarios to demonstrate the potential benefit of REITs during different possible future conditions. Rather than arbitrarily making adjustments to the R Fund's return, risk, and correlation, we decided to make them in relation to the C Fund. The objective of the C Fund is to match the performance of the S&P 500 Index, a broad market index made up of stocks of 500 large- to medium-size U.S. companies. Figure 1 illustrates that before the R Fund was introduced into the optimization process, the C Fund clearly dominated. Our intention with the sensitivity analysis was to make our adjustments relative to the C Fund in order to determine if and when the C Fund's dominance reemerges.

Table 4 shows the original optimization inputs as well as the adjustments based on a scenario that involved decreasing the R Fund's return, with volatility and correlations remaining at historical levels. Figure 4 graphically depicts the optimal investment allocations with the current five funds (noted as the original case) as well as the optimal investment allocations after the adjustments discussed above were applied. Decreasing the R Fund's return restores the dominance of the C Fund for optimal portfolios with moderate to aggressive risk tolerance, with some allocation to the R Fund remaining appropriate until the S Fund dominates for the highest levels of risk. However, it is important to note that even after the return adjustments were applied, the R Fund appeared in 88% of the optimal portfolios. When other scenarios were also examined, it was clear that the historical investment characteristics of REITs make real estate an appropriate addition to a diversified portfolio of equity and fixed income assets, for a very wide range of investor risk tolerance and for a substantial range of unfavorable adjustments to historical return, volatility, and correlation.[1]

[1] Other scenarios explored included: 1) Increasing R Fund volatility, with return and correlations remaining at historical levels, 2) Increasing correlation between the R Fund and C Fund, with return and volatility remaining at historical levels, 3) Decreasing R Fund return and volatility, with correlations remaining at historical levels, and 4) Decreasing R Fund return, increasing R Fund volatility, and increasing correlation with the C Fund.

VIII. Conclusion

Our analysis has served to show that a REIT index fund increased returns and lowered risk when added to portfolios of G, F, C, S and I investment funds. These results are mainly due to the historical diversification benefits that a REIT fund had to offer over the time period analyzed. As an additional basis for comparison with the original R Fund analysis, which utilized the NAREIT Equity REIT Index, an alternative REIT benchmark was considered. The results using the alternative REIT benchmark were very similar to the results conducted using the NAREIT index. Lastly, after a series of "what if" scenarios were conducted in which the return of the REIT fund was lowered, the R Fund was still an appropriate addition to a diversified portfolio of equity and fixed income assets In conclusion, it has been determined that a REIT index fund would make available to Federal Thrift Savings Plan participants certain diversification benefits not currently available from the G, F, C, S, and I investment funds.

Table 1: Risk and Return Attributes
1988 to 2004

	Compound Annual Total Return (%)	Average Annual Total Return (%)	Standard Deviation of Annual Total Returns (%)
G Fund	6.6	6.6	1.5
F Fund	7.9	8.1	5.4
C Fund	12.3	13.7	17.8
S Fund	12.1	13.8	19.9
I Fund	5.7	7.4	19.3
R Fund	12.7	14.0	16.6

Table 2: Correlation of Annual Total Returns
1988 to 2004

	R Fund	G Fund	F Fund	C Fund	S Fund	I Fund
R Fund	1.00	-0.25	0.14	0.21	0.41	0.23
G Fund	-0.25	1.00	0.29	0.20	0.02	-0.19
F Fund	0.14	0.29	1.00	0.21	0.09	-0.21
C Fund	0.21	0.20	0.21	1.00	0.88	0.64
S Fund	0.41	0.02	0.09	0.88	1.00	0.74
I Fund	0.23	-0.19	-0.21	0.64	0.74	1.00

Table 3: Performance of Alternative REIT Benchmark Measures
1988 to 2004

	Compound Annual Total Return (%)	Average Annual Total Return (%)	Standard Deviation of Annual Total Returns (%)
Original R Fund	12.75	13.96	16.63
Alternative R Fund	12.91	14.01	15.95

Table 4: Optimization Inputs Utilized for Sensitivity Analysis in Figure 4 Assuming Lower R Fund Returns 1988 to 2004

	Average Annual Total Return (%)	Standard Deviation of Annual Total Returns (%)	Correlation with C Fund
Original Case (R Fund return set equal to historical R fund return)	13.96	16.63	0.21
Case 1 (R Fund return assumed to be 90% of C Fund return)	12.36	16.63	0.21
Case 2 (R Fund return assumed to be 80% of C Fund return)	10.99	16.63	0.21
Case 3 (R Fund return assumed to be 70% of C Fund return)	9.62	16.63	0.21

Figure 1: Optimal Investment Allocations with Current 5 Funds Based on Historical Data over the Time Period 1988 to 2004

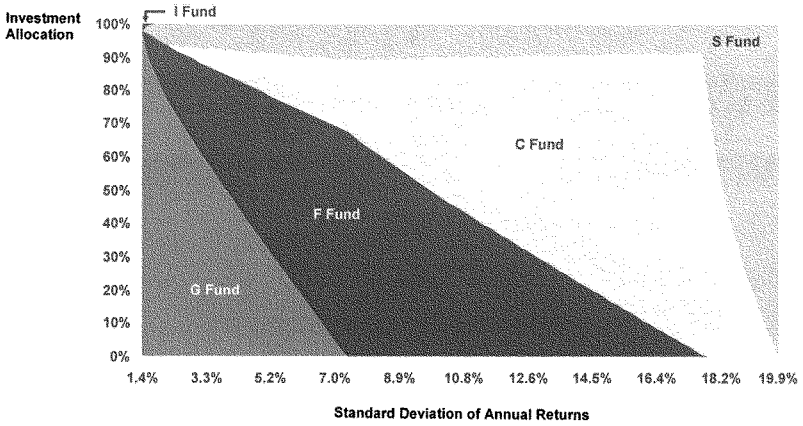


Figure 2: Optimal Investment Allocations with Current 5 Funds and R Fund Based on Historical Data over the Time Period 1988 to 2004

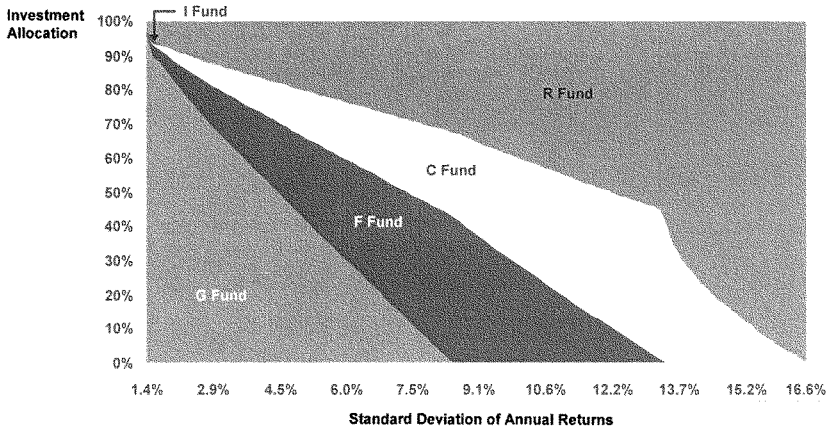


Figure 3: Optimal Investment Allocations Using Alternative REIT Benchmark Based on Historical Data over the Time Period 1988 to 2004

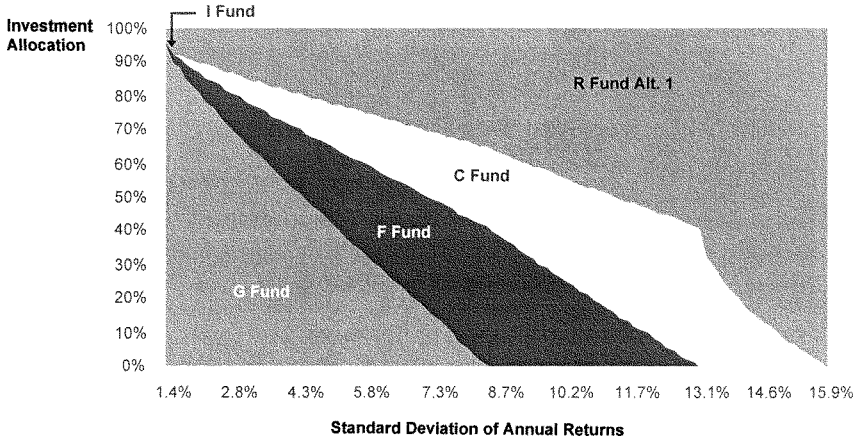
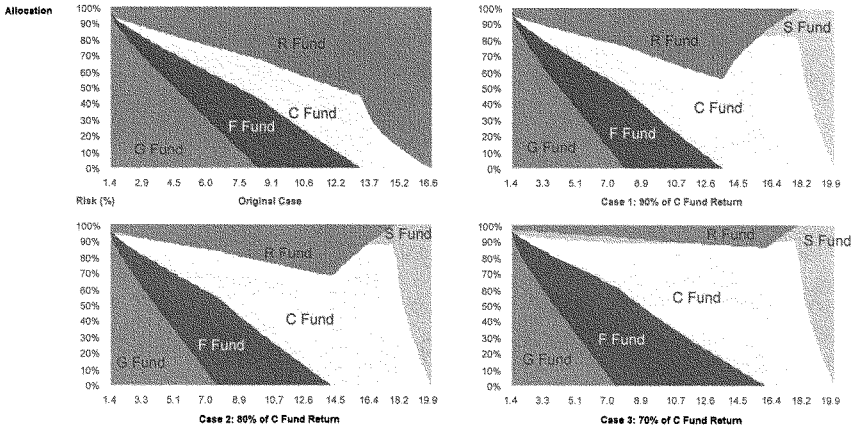


Figure 4: Optimal Investment Allocations Utilizing Sensitivity Analysis Based on Historical Data over the Time Period 1988 to 2004 but Using Assumed Lower R Fund Returns



Mr. PORTER. And the managing director, Amy Schioldager.

STATEMENT OF AMY SCHIOLDAGER

Ms. SCHIOLDAGER. Good afternoon, Mr. Chairman and members of the committee. My name is Amy Schioldager, and I am the head of U.S. equity indexing products at Barclays Global Investors. In that role, I am responsible for the management of our REIT index funds. I appreciate the opportunity to discuss with you the issues relating to adding a REIT index fund option to the Thrift Savings Plan.

As members of this committee know, since 1988, BGI has provided investment management services to the Thrift Savings Plan. We take great pride in the mandates that we have been awarded by the TSP under which we manage four of the plan's five investment options: large and small capitalization U.S. equities, U.S. fixed income, and international equity. The fifth option is managed by the U.S. Treasury and invests in U.S. Treasury securities.

As the members of this committee are well aware, diversification of asset classes is an important element in effective investment management. By ensuring that a portfolio is not dependent on any one asset class for performance, diversification improves the potential for better returns over the long-term. Specifically, Mr. Chairman, REITs offer to the investor the ability to gain exposure to real estate through an investment which has, on average, sufficient liquidity to gain access to that asset class cost-effectively.

Furthermore, REITs have a low correlation to other asset classes. For example, the performance of REITs versus the S&P 500 Index, since 1963, shows annual return differences greater than 20 percent, both positive and negative. It is also worth noting, with regard to the TSP, that REITs represent 0.55 percent of the S&P 500 Index, the benchmark tracked by the C Fund, and 8.1 percent of the Dow Jones/Wilshire 4500 Index, the benchmark tracked by the S Fund. As a result, TSP participants investing in these two funds are already getting an exposure to REITs.

Mr. Chairman, BGI is the largest manager of tax-exempt REIT index funds in the world, with approximately $10 billion of assets under management in U.S. REITs. We have a long and deep experience managing investments in this asset class. In that light, there are a number of issues we would encourage the committee to consider as it contemplates the inclusion of REITs in the TSP. Let me focus on two critical ones, costs and liquidity, two subjects we initially discussed in a letter dated January 25, 2005, to Chairman Davis in response to his January 5th letter to us.

First, consider costs. A key question is can a REIT option be offered to TSP participants at or near the same cost as the current investment options. There are two costs that need to be considered: investment management fees and transaction costs. With respect to management fees, there are many factors that potential providers would consider in developing a fee quote for such a product, including the complexity of managing the investment strategy and their assessment of the competitive landscape.

Obviously, we cannot comment on what other providers might bid for this business. What we can say is that management fees for institutional REIT index funds tend to be in the range of 10 to 15

basis points, while fees for REIT index mutual funds are in the 25 basis point range. Given the potential size of investment by TSP participants, we expect that management fees would likely be lower than these levels. But they would also likely be modestly higher than the fees currently charged for some of the existing TSP investment options.

Transaction costs are also an important consideration given the size of potential cash-flows and the frequency with which many TSP participants trade. Depending on the size of the trade and given current levels of market liquidity, we would estimate that total transaction costs, including commissions, bid/ask spread, and market impact, could range from 26 basis points for a $10 million trade to 59 basis points for a $100 million trade.

Given recent index methodology changes, the expected T cost for $100 million we expect would be 40 basis points. To show the comparative illiquidity of REITs, estimated transaction costs for a $10 million trade in the C Fund benchmarked to S&P 500 is approximately 7 basis points, while a $100 million trade is approximately 9 basis points.

A second important issue is whether the REIT marketplace offers sufficient liquidity to absorb the potentially large daily market flows, in or out, generated by TSP participants. Our analysis of the REIT marketplace shows that most of the REIT indices have liquidity characteristics similar to the U.S. small capitalization equity market in which the TSP's current Dow Jones/Wilshire 4500 Index option, the S Fund, invests.

We have worked with TSP staff to establish procedures that have cost-effectively managed cash-flows in this market since this option was added to the plan in 2001. Assuming that one of the more liquid REIT indices were selected as the benchmark for a potential new option, we believe that these same procedures would likely work as effectively for a REIT index fund option.

Before concluding, I would like to make a further point. When considering additional options to the Thrift Savings Plan, there are many asset categories worthy of evaluation. We would suggest, as the leadership of the TSP has in their testimony, that a broad view of candidate asset classes be taken when determining if REITs are the most appropriate potential addition. There are indeed others worthy of consideration, such as emerging market equities and commodities. Before selecting a new investment option, it would be appropriate to analyze the full spectrum of asset class options available to evaluate their diversification potential and return opportunities, and then select the most suitable additional options.

Mr. Chairman, I thank you for the opportunity to speak with you today, and I look forward to answering any questions you may have.

[The prepared statement of Ms. Schioldager follows:]

Statement of Barclays Global Investors

Amy Schioldager
Head of US Equity Indexing Products

Before the House Subcommittee on the Federal Workforce and Agency Organization

April 19, 2005

Good afternoon, Mr. Chairman and members of the Committee. My name is Amy Schioldager and I am the Head of US Equity Indexing Products at Barclays Global Investors. In that role I am responsible for the management of our REITs index funds. I appreciate the opportunity to discuss with you the issues relating to adding a REIT index fund option to the Thrift Savings Plan. As a long-term provider of investment management services to the Thrift Savings Plan, BGI is pleased to offer our experience and expertise.

I'd like to begin with a brief overview of BGI and our relationship with the Thrift Savings Plan. I will then discuss the advantages of REITs as an asset class as well as BGI's experience managing REIT index funds. Finally, I'd like to discuss several of the key issues surrounding the addition of REITs to the Thrift Savings Plan.

Mr. Chairman, we at BGI are honored to have served as an investment manager for the TSP since 1988, and we take our responsibilities for the management of the retirement assets of the Federal workforce very seriously. We take great pride in the mandates that we have been awarded by the TSP to manage four of the plan's five investment options—each an index fund that tracks a widely followed stock or fixed income benchmark. It is important to note that we have successfully retained this relationship in regular, highly competitive bidding processes since the TSP's inception.

Participants in the Thrift Savings Plan can invest in five separate funds: the C Fund (based on large-capitalization US equities), the S Fund (based on mid- and small-capitalization US equities), the F Fund (based on the Lehman Aggregate Long-term Bond index), the I Fund (based on the MSCI Europe Australia Far East (EAFE) index of non-US equities) — as well as the G Fund, which invests in U.S. Treasury securities. From a pure investment perspective, introducing additional asset class options to the TSP could benefit participants by increasing the diversification of their menu of investment choices.

Allow us a few words about the context and history of REITs.

Institutional investors have long valued real estate as a critical element in their portfolios. Real estate generally has a low correlation to other asset classes, so it diversifies a portfolio that is invested primarily in stocks and bonds. Rental income can deliver strong

cash flows, and can provide a hedge against inflation. Obviously, for individual investors, however, investing in direct real estate requires a broad set of specialized skills—as well as a great deal of time—which is impractical for most investors.

The creation of Real Estate Investment Trusts (REITs) in 1960 introduced an easier way to invest in real estate especially for individual investors and small to mid-size defined benefit plans which lack the asset size to develop a well-diversified direct real estate portfolio. REITs are publicly traded companies that own and operate commercial real estate as their primary business. They offer a convenient way for investors to gain exposure to a diverse set of real estate holdings, across property types and geographic markets. REITs can be thought of as real estate stocks, and they are traded on the major stock exchanges. The REIT market grew dramatically in the 1990's and today there are approximately 160 publicly traded REITs in existence with a market capitalization of more than $250 billion. They have become increasingly accepted as part of the retirement plan portfolio, with one out of eight defined contribution plans including REITs as an investment option and almost 4 percent of the assets in the largest 1,000 defined benefit plans invested in this category.

REITs offer to the investor the ability to gain exposure to real estate through an investment, which has, on average, sufficient liquidity to gain access to that asset class cost effectively. Furthermore, REITs have a low correlation to other asset classes. For example, the performance of REITs versus the S&P 500 Index since 1963 shows annual return differences greater than 20%--both positive and negative. Moreover, the correlation between REITs and equities actually declined during the 1990s, implying an increase in their diversification properties. This coincided with an increase in the number, breadth and size of the REIT sector as well as REITs becoming more diversified across property types and geographic markets.

As the members of this Committee are well aware, diversification is critically important in investing. By ensuring that a portfolio is not dependent on any one asset class for performance, diversification improves the potential for better returns over the long term. Thus, it is important to note that while REITs are publicly traded like stocks, they are a different asset class and their return pattern can behave quite differently from the broader US equity market. However, it's also worth noting that REITs represent 0.55% of the S&P 500 Index, the benchmark tracked by the C Fund, and 8.10% of the Dow Jones/Wilshire 4500 Index, the benchmark tracked by the S Fund. As a result, TSP participants investing in these two funds are already getting an exposure to REITs.

Mr. Chairman, BGI is the largest manager of tax-exempt REIT index funds in the world, with approximately $10 billion of assets under management in US REITs. We have a long and deep experience managing investments in this asset class. In that light, there are a number of issues we would encourage the Committee to consider as they contemplate the inclusion of REITs in the TSP. Let me focus on two critical ones: costs and liquidity, two subjects we initially discussed in a letter, dated January 25, 2005, to Chairman Davis in response to his January 5 letter to us.

First, consider costs. A key question is: can a REIT option be offered to TSP participants at or near the same cost as the current investment options? There are two costs that need to be considered: investment management fees and transaction costs. With respect to management fees, there are many factors that potential providers would consider in developing a fee quote for such a product, including the complexity of managing the investment strategy and their assessment of the competitive landscape.

Obviously, we cannot comment on what other providers might bid for this business. What we can say is that management fees for institutional REIT index funds tend to be in the range of 10 to 15 basis points, while fees for REIT index mutual funds are in the 25 basis point range. Given the potential size of investment by TSP participants, we expect that management fees would be lower than these levels, but they might be modestly higher than the fees currently charged for some of the existing TSP investment options.

Transaction costs are an important consideration given the size of potential cash flows and the frequency with which many TSP participants trade. Depending on the size of the trade, and given current levels of market liquidity, we would estimate that total transaction costs (including commissions, bid/ask spread and market impact) could range from 26 basis points for a $10 million trade to 59 basis points for a $100 million trade. To show the comparative illiquidity of REITs, estimated transaction costs for a $10 million trade in the C Fund benchmarked to the large capitalization S&P 500 Index would be approximately 7 basis points, while a $100 million trade would be approximately 9 basis points.

A second important issue to consider is whether the REIT marketplace offers sufficient liquidity to absorb the potentially large daily market flows (in or out) generated by TSP participants. Our analysis of the REIT marketplace shows that most of the REIT indices have liquidity characteristics similar to the US small-capitalization equity market in which the TSP's current Dow Jones/Wilshire 4500 Index option, the S Fund, invests. We have worked with TSP staff to establish procedures that have cost-effectively managed cash flows in this market since this option was added to the plan in 2001. Assuming that one of the more liquid REIT indexes were selected as the benchmark for a potential new option, we believe that these same procedures would work just as effectively for a REIT index fund option.

Before concluding I'd like to make a further point. When considering additional options to the Thrift Savings Plan, there are many asset categories worthy of evaluation, and we encourage the Committee to take a broad view of candidate asset classes when determining if REITs are the most appropriate potential addition. There are indeed others worthy of consideration, such as emerging market equities and commodities. Before selecting a new investment option, it would be appropriate to analyze the full spectrum of asset class options available, to evaluate their diversification potential and return opportunities and then select the most suitable additional option(s).

Mr. Chairman, since its founding, BGI has been focused on a single global investment philosophy, which we call Total Performance Management. In brief, our objective is to

deliver superior investment results by efficiently capturing the returns of market indexes while rigorously controlling all risks and minimizing trading and other implementation costs. This simple, yet profound approach is rather unique in the industry, and helps us avoid investment "fads" or dependence on star managers or stock pickers.

We believe that philosophy has well served participants in the TSP and our other clients. And we also believe that those principles—managing risks and controlling costs while capturing the returns of an asset class—are the ones that should underscore the addition of any new investment options to the Thrift Savings Plan.

Mr. Chairman, I thank you for the opportunity to speak with you today and I look forward to answering any questions you may have.

Mr. PORTER. Thank you. We appreciate your testimony.

I would like to begin. Regarding the costs, if you could explain how costs are incurred with REITs and what we can do to be more conservative in those expenses, if in fact we do include these?

Ms. SCHIOLDAGER. Is that management fees or transaction costs for trading?

Mr. PORTER. Both, please.

Ms. SCHIOLDAGER. OK. And what exactly—I am sorry. Did you just want——

Mr. PORTER. Could you explain how the costs are incurred for investments in the REIT?

Ms. SCHIOLDAGER. OK.

Mr. PORTER. You mentioned up to 25 percent. Could you explain those costs to us, please?

Ms. SCHIOLDAGER. Sure. Well, the two costs that I spoke to, one are investment management fees, and those are the costs that an investment manager would charge the Thrift Savings Plan for managing those assets. What we see out there currently is for institutional REIT index funds, fees are somewhere in the range of 10 to 15 basis points. If you look at REIT mutual funds—and, again, these are REIT index mutual funds—those fees are more in the neighborhood of 25 basis points.

Now, what I would say is given the size of the TSP Fund, that it is likely, it is possible, I should say, that those fees would be less than that. It is also likely, given the complexity of the management of REITs compared to the current lineup that TSP has, that the fee would also be greater than what they are currently paying for their other options. So that would be the first piece, the management fee.

The second fee is the transaction costs associated with buying and selling REITs in the marketplace. Right now all participants, when they trade the various options, whether they are going in or out, are paying transaction costs associated with those trades. So the fees that I spoke to are transaction costs associated with going to the market and completing those trades. For an S&P 500 fund, we would expect those fees to be 7 basis points for a $10 million trade and roughly 9 basis points for a $100 million trade.

So that gives you an idea of what the current costs are for the S&P 500 fund. The extended market fund, which is the Wilshire 4500 Fund, the transaction costs there, just to give you another data point, would be 18 basis points for $10 million and 23 basis points for $100 million.

On the same magnitude, what I was looking at was a broad-based REIT index where the costs would be approximately 40 basis points for a $100 million trade and approximately 16½ basis points for a $10 million trade. So that gives you an idea of the difference in costs associated with REITs versus the current fund options.

Mr. PORTER. Is there a way that we can minimize those costs?

Ms. SCHIOLDAGER. Well——

Mr. PORTER. I know we are not negotiating today.

Ms. SCHIOLDAGER. Right. Thank you. The investment management fees would go out for competitive bid, so depending on what the competitive landscape is and the competitors that are involved, that would determine the final bid on that.

Mr. PORTER. Thank you. I appreciate that.

Mr. Davis.

Mr. DAVIS. Thank you, Mr. Chairman.

Mr. Wechsler, Ms. Schioldager manages REITs index funds for Barclays Global Investors, and she raised the issue as to whether or not REITs offer sufficient liquidity to absorb the potentially large daily market flows, in or out, generated by TSP participants. How would you respond to that concern, and do REITs offer the liquidity to absorb the large flows in and out of the participants?

Mr. WECHSLER. Mr. Davis, it is my understanding that as far as liquidity is concerned, there is more than sufficient liquidity to operate an index fund. Barclays does that through their exchange traded fund on a regular basis, and it has been represented, I believe, in the past that liquidity, at least by the TSP staff, is not a significant issue in their mind at this point. And I think the larger issue is tied, in my understanding, to some of these transaction costs and how they can be driven down.

Mr. DAVIS. Ms. Schioldager, do you agree that is not——

Ms. SCHIOLDAGER. Well, we looked at how—there is approximately $1 billion worth of REITs that change hands every day, so that gives you an idea of the marketplace for REITs. In contrast to that, it is many billion in S&P 500 space. So they are less liquid than you would see in the other plan options. If we were to assume, as a starting point, that the TSP could be approximately 10 percent of average daily volume, that would mean that we could handle up to $100 million a day from the plan participants within the fund. I would consider that to be on the high side in terms of what we would be able to trade on a daily basis.

Mr. DAVIS. Dr. Ibbotson, I understand that your firm was commissioned by the National Association of Real Estate Investment Trusts to study a REITs fund to the TSP. However, as an investment research firm, what asset classes other than REITs could you recommend that the Board and Congress consider for the TSP, if any?

Mr. IBBOTSON. Well, there are many asset classes that you could consider. You could consider—I mean, things were brought up such as alternative investments, hedge funds, commodities, energy. These are all possibilities.

I will say that real estate is sort of the natural place to look for the next addition because real estate is such a huge part of the economy and, actually, not all of real estate is represented by the stock market. REITs are, and it is understandable that you are looking at real estate investment through REITs, because you don't have all these agency problems; you don't have to worry about the direct real estate and you don't have to worry about who is pocketing what. It is a much more straightforward investment to invest in REITs.

So real estate is a natural place to go as a next category, but there is a myriad of categories, and many of them were brought up. I think it would be reasonable to look at the whole set of categories.

Mr. DAVIS. Do you have specific knowledge of TSP participants' investment behavior?

Mr. IBBOTSON. I am not an investor in TSP, and I have not managed any TSP funds, so I have no direct knowledge of the participants other than general knowledge of who they are.

Mr. DAVIS. Ms. Schioldager, are there other asset classes aside from REITs that you would consider worth reviewing by the Board.

Ms. SCHIOLDAGER. Yes, I think there are. A couple of them I mentioned in my statement. I think emerging markets would be worthwhile looking at; I would also add commodities and TIPS as possible other investment options when looking at what else the TSP could add in terms of their lineup.

Mr. DAVIS. Thank you very much, Mr. Chairman.

Mr. PORTER. Thank you.

Congresswoman.

Ms. NORTON. Thank you, Mr. Chairman.

Mr. Wechsler, you don't have any objection, do you, to their looking at the whole universe of funds in order to decide whether any funds should be added, REIT among them?

Mr. WECHSLER. I have no objection whatsoever. In fact, I would concur with Ms. Schioldager's expression of some of the other areas worth looking at.

Ms. NORTON. That, it seems to me, was the best point the prior panel made, that if you are going to do it, look at all your options before jumping, even though this option looks particularly attractive now.

Mr. Wechsler, during questioning we brought out the rather minute investment in REITs now. I wasn't able to determine why that was the case, given the returns, long-term and short-term. I wonder whether you have any hypothesis about that, No. 1? And, No. 2, whether TSP might accomplish something close to what you advocate simply by increasing the percentage of investment in REITs among the funds they already have?

Mr. WECHSLER. I will answer the two parts you presented. I see there is one reason why the Thrift Savings Plan participants today have, on a relative basis, such a small exposure to real estate, given its size in the economy, and that is because commercial real estate investment is significantly under-represented through the stock market.

So you are not capturing that part of our economy, that part of our productivity, that part of our services when you invest solely in the stock market. But for a plan like the TSP, a low-cost index plan, the way you will capture real estate, and the only way you can capture real estate consistent with the other five options, is through an index fund based on publicly traded equity REITs today.

That is why we are here. That is why we are talking about it, because, as you heard in my testimony, large institutional investors routinely allocate 10 percent, 8 percent, 7 percent to real estate. There is no earthly way possible you can do that through the TSP today unless you vastly over-allocate to the S Fund. And even if you did you wouldn't get there. As you see in exhibit 13 of my written statement, you would have to have taken 80 percent allocation to the S Fund to have a 5 percent allocation to real estate. No one would recommend that.

Ms. NORTON. Ms. Schioldager, it seems to me that is a very important point that Mr. Wechsler has just made. What do you say to the point he has just made about what looks to be the inability of the TSP to capture the growth in real estate, given the way it is now structured, except by going into REITs?

Ms. SCHIOLDAGER. I believe that is a true statement. What Mr. Wechsler is saying is that the real estate market as a whole is roughly a $4 to $10 trillion market, depending on what you include in that calculation. So if you include governmental land, for instance, it is a much larger number. What is available to invest in the public market through REITs is about $250 billion. So you can't capture, in the current TSP lineup, a 10 percent allocation to REITs or to real estate through purchasing REITs. That is an accurate statement.

The question of what is the appropriate allocation to REITs I think is a completely different question. My experience has been that defined benefit plans typically hold somewhere in the neighborhood of 4 to 5 percent in a real estate allocation, not the 7 to 10 percent that Mr. Wechsler has spoken to.

Ms. NORTON. He is saying you couldn't even hold that.

Aren't you saying you couldn't even hold that in TSP?

Mr. WECHSLER. What I am saying is the only way you could hold it, no one would advise you to do under the current plan lineup. And I would agree with Ms. Schioldager's comment that, on average, traditional pension plans generally have an allocation of plus or minus 5 percent.

But some of the larger plans I have cited, such as CalPERS in California, such as General Motors and others, some of the larger have had traditionally and have larger allocations to real estate for all the reasons I talked about in my statement, which is the significant income overtime, the price appreciation overtime that more than keeps pace with inflation, and the low correlation of real estate with other stocks and bonds. And those are very significant investment attributes that few other asset classes provide, and it is provided to the public markets by REITs representing real estate, which is what——

Ms. NORTON. Well, one of the things I hope this study brings out is, in addition to whether or not REITs is the best among several possible expansions, whether or not there is any increase beyond the less than 1 percent in REITs that would be consistent with even the present structure of TSP. That is very bothersome, that we are unable to take hold of real estate in any appreciable way.

I have to ask you, though, Mr. Wechsler, is this the right time to be talking about—would a prudent TSP be looking—let us assume the following scenario, that for the first time you could go into real estate and you look at what has happened to real estate, because everything else is you know where. Real estate is one of the few growth opportunities that has not seemed to dissolve under us, and that leads many to believe that real estate is, if anything, overpriced.

And watch out, I live in Washington, DC. That being the case, even if this is done or even if this proves prudent to do at some point, would this not be perhaps the time to pass and do it a little later?

Mr. WECHSLER. There is no time like the present generally in life to do things, and it seems to me, as was indicated earlier, it has been many, many years since the Thrift Savings Plan added new options. There are only five options today, one of which is——

Ms. NORTON. Mr. Wechsler, I am talking about the price of adding options on top of the transaction costs. Very specifically, my question is isn't real estate overpriced everywhere you look, in large part because everything else has gone—I am trying to think of a polite word for what has happened to everything else, but surely you know what I mean. And I am simply saying one of the things that surely a prudent fund would have to watch out for is when is the best time to do this, and I don't think that you mean it when you say there is no time like the present, because you don't mean that for each and every investment you would make. There are some you wouldn't make and there are some you would make now.

Mr. WECHSLER. And what we advocate and I believe, and I think you have heard it not only from this panel, from Chairman Saul and Mr. Amelio as well, is that diversification is the object here, to provide Federal workers with the ability to diversify their investment portfolios for retirement savings. And we are talking about a program that is supplemental to a pension and Social Security, and can withstand and should benefit from additional choices and asset classes such as real estate.

And I think it is important to distinguish between the single-family housing market and the commercial real estate market. Both have done well over recent years, but we are not resting our case on the performance of the last 1 year, 3 years, 5 years. As I think the chairman pointed out earlier, the track record is strong for a decade, for 20 years, for 30 years.

Ms. NORTON. Mr. Wechsler, that is a fair point. That is a fair point, and I take your point.

Let me ask you one more question, and that is, goodness, Ms. Schioldager's testimony about this huge difference in basis points between the transaction costs. These are not just little differences, 59 basis points, 9 basis points. They are huge. There was testimony without this kind of particularity in the last panel that would make anyone stop, that, hey, this is a different kind of investment. There is something different here. I would like you to speak to the difference and how you respond to such huge transaction costs, very much larger than anything TSP has ever contemplated before.

Mr. WECHSLER. I think it is a very good question, and I would respond in two parts. The first part is I believe—and I am not the expert and Ms. Schioldager is the expert on this—but the reason the transaction costs, until further determined, looks somewhat higher than the other funds is because we are talking about a narrower basket.

We have been talking about five baskets, now possibly having a sixth. The plan testified earlier they may want to look at multiple additions or slicing and dicing the current options into more by slimming some of them down. It seems to me that part of the issue here is the number of securities in the basket that are being traded, so it is a narrower base in terms of the transaction costs and

the way the market operates to withstand that. And I am sure Ms. Schioldager will——

Ms. NORTON. Mr. Wechsler, I am not getting it. It sounds to me to be something structurally different between the kinds of investments, very traditional investments that TSP makes and real estate. Perhaps Ms. Schioldager would add to what you have said to clarify.

Mr. WECHSLER. I would just want to complete, and then I am very eager to hear what she has to say. But they are not structurally different. These are publicly traded companies; they were equity securities, the same as in the S and C Fund. And what is important to note when we consider cost is also benefit.

So you cannot only look at the transaction costs. If it is somewhat higher, what benefit is added by having this option? And I think what our testimony shows is that over long periods of time the added return in combination with the lower volatility and the low correlation with the other categories brings a benefit to the portfolio that is well worth any marginal additional costs.

Ms. NORTON. Now, Ms. Schioldager, just based on what the figures show, which is real estate has done better over the long-term, I am sure, taking into account—please correct me if I am wrong—what are the transaction costs? I mean, when one looks at those figures that the panel had and that the chairman had, and those figures are at least comparable and, in fact, better, does that take into account transaction costs?

Mr. SAUL. Can I comment on that? Because I think you are talking about my figures here.

The NAREIT figures are a cap-weighted index, there are no transaction costs in there. However, the transaction costs, although they are higher on the REITs than they are on, say, the S Fund or the C Fund, these are index funds, and you have to buy them on the way in and you have to buy and sell some to take care of some cash inflows and outflows.

But, for the most part, the transaction costs are a one-time occurrence; they occur when you go in. And since you are not trading a very high percentage of the portfolio—and perhaps Ms. Schioldager can address that—but since the portfolio is not heavily traded, the transaction costs are actually the smaller part of the fee, compared to, say, the management fee that she was also talking about.

Ms. NORTON. Ms. Schioldager.

Ms. SCHIOLDAGER. The transaction costs that I spoke to were based on the MSREIT Index, which is an index that holds about 120 securities. Remember that the REITs that are available in the public market are just over 200 to 250 REITs available in the market, comparing that to the broader U.S. equity market, where you have 5,000 securities that are available. So it is a very small subset of the U.S. equity market.

The transaction costs are more expensive simply because of the liquidity associated with REITs. Most REITs are small-cap and mid-cap stocks, so, given that, the liquidity associated with small-cap stocks mean that you pay more when you are buying them. It is the case that the transaction costs are only occurred [sic] at the time that you purchase a fund, so this isn't—you know, if you were

to purchase once and you are a long-term holder, that is one transaction cost that is incurred, and there are no additional transaction costs. But if you are buying and selling the fund, that is what you would expect to pay each time there is a purchase or a sale.

Ms. NORTON. Thank you very much, Mr. Chairman.

Mr. PORTER. Mr. Van Hollen.

Mr. VAN HOLLEN. Thank you, Mr. Chairman.

I just want to pursue the issue of what the trend is in the private sector, especially with respect to large employers, because my understanding is that the trend is toward allowing employees to have a REIT specific option within the portfolio and that is especially true among some of the largest employers. Could you just all respond to that so we can get the facts on the table?

Mr. WECHSLER. I would say that as far as the defined benefit world, the traditional pension plans out there, they have long invested in real estate, and increasingly the trend is that part of their real estate investment is taking place in REITs, in some cases all, in some cases part.

As far as 401(k) plans, which have been a newer addition, relatively speaking, on the retirement savings playing field, we have begun to see a substantial up-tick in the number of plans that have a distinct real estate option for their employees, utilizing REITs generally, and that has, in the last, I would say, 4 or 5 or 6 years, tripled or quadrupled percentage-wise. It is a significant upward trend.

Mr. VAN HOLLEN. Any other comments on that?

Ms. SCHIOLDAGER. The only thing, I would agree that most defined benefit plans do have a real estate allocation. Many of them gain their real estate allocation through direct access to real estate, so they are buying individual properties. Smaller defined benefit plans are utilizing REITs for their access to real estate. In terms of defined contribution, the statistics that I have show on that one in eight defined contribution plans have a real estate or a REIT option in their lineup of funds.

Mr. VAN HOLLEN. Do you know what the trend is, though? Has it been increasing?

Ms. SCHIOLDAGER. It is increasing.

Mr. VAN HOLLEN. And is that true especially among some of the larger employers?

Ms. SCHIOLDAGER. Absolutely.

Mr. VAN HOLLEN. The other question I had is on the issue of taking a time to look at various new investment options among the TSP, and whether or not the REIT option can be distinguished from others because it is under-represented in the stock market and the other options, the plans that we are talking about. Is that something that distinguishes the REIT option from some of the other investment proposals that we might be looking at, or would they also be things that are under-represented?

Ms. SCHIOLDAGER. The other investment proposals that I spoke to in terms of emerging markets, commodities, and TIPS, are not represented in the current lineup of funds; so, whereas you are getting some real estate exposure through both the S&P 500 Fund and the Wilshire 4500 Fund, you are not getting exposure to commodities or emerging markets in any of the plan options.

Mr. VAN HOLLEN. In any of the options.

Ms. SCHIOLDAGER. That is correct.

Mr. WECHSLER. But, Mr. Van Hollen, I think part of the thrust of your question was the broader economy, and whether the stock market and the bond market adequately reflects other aspects of the economy. And I think it is fair to say that the commercial real estate sector of the economy is probably the last major sector that has been moving into the public capital markets, both in terms of debt and equity. And that has happened over the last few decades in a very significant manner, but there is still much more to be done.

So I think you would be hard-pressed to find in the public capital markets another sector of the economy that is under-represented in the public markets the way commercial real estate is.

Mr. VAN HOLLEN. Well, that is why I asked to the extent that the real estate portion.

Mr. WECHSLER. Which, by the way, is why, for many years, as Ms. Schioldager pointed out, defined benefit plans have directly purchased real estate. However, that is not a solution for the Thrift Savings Plan. I don't think Congress will be having it directly by office buildings and shopping malls around the country, only indirectly, hopefully, through REITs.

Mr. VAN HOLLEN. Thank you.

Thank you, Mr. Chairman.

Mr. PORTER. Thank you very much. That will conclude the testimony today. We sure appreciate your being here, all those folks——

Ms. NORTON. Mr. Chairman, could I ask one more question?

Mr. PORTER. Yes, you can.

Ms. NORTON. There is a concern among employees and there was a concern with the Board that people fall away given increased complexity, and that is one of reasons they want to just keep it simple, keep it simple. Particularly given the testimony we have just heard about the difference in basis points between the two kinds of funds on the down side, and on the upside, if I may simply refer to Mr. Wechsler's testimony that REIT stock returns combine the growth characteristics of other stocks and the income characteristics of bonds, there is something to that, I think. He also talks about the low volatility.

There is every reason to want to capture some of that, frankly, conservatism for Federal employees. I wonder if a fund like this or similar funds, given the huge difference in transaction costs, which would give me some pause in simply saying to employees which do you want to invest in, here is REITs and then here are all the rest of them. Would you think it appropriate to red flag transaction costs? I am sure people are told about transaction costs.

But when you have this kind of difference in transaction costs, and somebody looks and sees the return on real estate or lives in a city like Mr. Davis and I live in, where they just think real estate is going to go through the roof and be this way forever, don't you think it would be important to alert people that the transaction costs for this stock is considerably greater than for another stock, and maybe we could get some of the problem on simplicity and people wondering what this is all about dealt with?

Mr. WECHSLER. The short answer is yes, I think more education in general about the costs and benefits of all investing is incredibly important, and I think that Federal workers of the Thrift Savings Plan should have full disclosure of any costs as well as the potential benefits.

Ms. NORTON. They already have that. They already have that. I am asking a very specific question. If you are going to do something where the transaction costs are many times what people are used to, and it is down in a footnote, I am wondering if we are being fair to ordinary workers like me who don't know this kind of stuff and don't read footnotes.

Mr. WECHSLER. What I took from Ms. Schioldager's explanation is that the transaction costs for REIT stocks were comparable to small and mid-cap stocks, and that certainly should be disclosed.

Ms. NORTON. Ms. Schioldager.

Ms. SCHIOLDAGER. I would agree with that, and I would say that full disclosure is the appropriate way to educate plan participants from the standpoint of buying a fund like this. And I would expect that if this was added to any lineup, that there would be some type of an educational process to inform participants about the investment in REITs and what that means, and part of that education would include the costs associated with it.

These stocks, as I said, are small-cap and mid-cap stocks, as are the funds in the Wilshire 4500 Fund. With that, the liquidity, because of the number of stocks that are available, is still quite a bit greater than what we see in the Wilshire 4500. So, by comparison, in the Wilshire 4500, a $100 million trade is 23 basis points. The number that I had quoted in my testimony was 59 basis points, although there are some structural changes in the index that we were using that changes that to 40 basis points. So it still is quite a bit more expensive than what we see in the 4500 Fund.

Ms. NORTON. Does the average person think about the basis points when exercising her option to go from one fund to another, as far as you know?

Ms. SCHIOLDAGER. I wouldn't be able to comment on what plan participants are looking at. I certainly do.

Ms. NORTON. I hope you do.

Mr. Wechsler.

Mr. WECHSLER. I just want to clarify one thing that would be helpful, not tied to the transaction costs, but to the other fees which have been discussed today. If my understanding is correct—and Mr. Ibbotson can correct me if not—but the work that we have done in this and that Ibbotson Associates has done has assumed higher fees because they were modeled on what is available out there publicly, although the testimony today has been that the management fees would be possibly only slightly higher than the other options.

But the numbers that we have presented to you today already factor in somewhat higher costs. So notwithstanding the higher costs, we think the benefits are still there, which is why I responded earlier to you, Ms. Norton, on not only the costs, but you have to look at the benefit.

And we think even at a little higher cost, the benefits are documentable and are the type of choice that Federal workers, as well

as workers in 401(k) plans generally, should have in terms of permitting them to include a meaningful allocation to commercial real estate in a diversified investment portfolio over a long period of time.

Ms. NORTON. There are very substantial benefits here, including the lack of volatility after the stock market volatility I have seen, and it is certainly true you cannot get something for nothing. If you want return on your investment, you better understand how this operates; and within TSP I would expect it to operate conservatively and to give back a considerable sum.

I think we should be interested in capturing what the real estate market has to offer. I am concerned about this notion of simplicity. I know, frankly, that I don't ask my investment advisor about transaction costs. I trust her; I know her. I go buy the stock.

So I just want to say that the characteristics that Mr. Wechsler points out in his testimony are very attractive. In a market economy, you simply have to look at those kinds of characteristics: strong returns, low volatility, low correlation with returns to other assets. That is something one would want to look at in a conservative fund.

At the same time, we in the Government would have to be very concerned. I would think it a tragedy if people began to fall away from TSP because they say, OK, now you have me, I don't quite know what to do.

And one of the things it seems to me we would have to do is to pay attention. The Advisory Committee also indicated that they had compunctions about moving forward now. I am sure they haven't heard all we have heard, but they do talk about simplicity. The Board talks about people falling away. Terrible thing to fall away from, since the Government puts its own money in as well.

I think perhaps there is a way to do this. If you are making a change that is very different, at least I think different from what you have done before in basis points, I think you would have to find some way to more than "educate" people. I think you would have to do something to warn people.

In any case, I will look forward to the work that is being done, work that you say, Mr. Wechsler, you have no opposition to, that would look at the entire range of options and then look at whether, given the range, this should be the one or if any ones should come forward consistent with the kind of fund we are trying to have here in the Government.

Thank you very much, Mr. Chairman.

Mr. PORTER. Again, I thank you all very much for being here and for your testimony. Very lively debate and discussion. I think it has elevated an additional option for Federal employees, and I would not say that this discussion will end only on this particular option.

I think that we should, as we move forward, look at some of the other plans that were mentioned today. And if there is one thing that has been consistent throughout the testimony is that the REITs have had a very strong return, and it is something we should give very strong consideration to. I appreciate everyone being here. Thank you all very much.

Mr. WECHSLER. Thank you.

Mr. IBBOTSON. Thank you.

[Whereupon, at 4:19 p.m., the subcommittee was adjourned.]

[The prepared statement of Hon. Elijah E. Cummings and additional information submitted for the hearing record follows:]

Opening Statement

Representative Elijah E. Cummings (MD-7)

Subcommittee on the Federal workforce and Agency Organization hearing entitled, "Real Estate Investment Trusts (REITs): Can They Improve the Thrift Savings Plan?"

U.S. House of Representatives
109th Congress

April 19, 2005 at 2 p.m. in 2203 Rayburn

Mr. Chairman, thank you for calling this critically important hearing on the potential consequences of including a real estate investment trusts (REITs) fund in the Thrift Savings Plan (TSP).

The Federal Employees Retirement System Act of 1986 established the TSP. Today it represents an essential component of federal employees overall compensation package and retirement benefits, and is the largest-defined contribution plan in the nation.

Currently, under the TSP federal employees can invest a share of their income in five funds, which include: the Common Stock Index Investment (C) Fund, the Small Capitalization Stock Index Investment (S) Fund, the International Stock Index Investment (I) Fund, the Fixed Income Index Investment (F) Fund, and the Government Securities Investment (G) Fund. Later this year, a Lifecycle (L) fund will be added to the TSP.

The recently introduced Real Estate Investment Thrift Savings Act, H.R. 1578, would direct the Federal Retirement Thrift Investment Board to add a REIT fund option to the TSP. While research indicates that REITs from 1988-2004 outperformed all of the funds under the TSP, these returns were not substantially correlated to the performance of other funds in the TSP. Such a low level of correlation could provide federal employees with an opportunity to diversify their assets, thereby minimizing their risk from the volatility of the market.

Although REITs have enjoyed increasing popularity as an investment option in 401 (k) plans in the private sector, there is some concern that the addition of a REIT fund may alter important characteristics of the TSP that have made it such a success. To minimize risk to TSP participants and to help ensure that they have a sufficient income in retirement, Congress established the use of broad based index funds, (cross sector investing) for the TSP. However, a REIT fund would only represent the real estate market (individual sector investing).

This begs the questions: would the inclusion of such a fund set a dangerous precedent for the TSP? What would prevent other individual sectors from pushing Congress to have a stand-alone fund within the TSP in the future?

Additionally, there is the concern that further fund additions may undermine a key attractive feature of the TSP—its simplicity. As the statement of James W. Sauber, Chairman of the Employee Thrift Advisory Council points out, too many choices in investment options can lead to investor confusion, reduced participation rates, and increased administrative costs.

In considering any changes to the highly successful TSP, Congress must exercise prudence and sound judgment. We must never lose sight of the fact that the retirement benefits the federal government offers to its federal employees are a central tool we use to attract and retain the best and the brightest to serve in the service of this great nation. Nor should we forget that our decisions will resonate in the retirement security of millions of federal employees who rely on TSP.

With that in mind, I believe we should use this hearing as an opportunity for some further deliberation before moving ahead on adding single sector funds to the TSP. We should seriously take into account the Federal Retirement Thrift Investment Board's opinion that adding a REIT fund to the TSP at this time would not be wise.

It seems just as sensible that we seriously consider implementing the type of comprehensive study on the various funds the Employee Thrift Advisory Board proposed before we add a REIT fund to the TSP.

I look forward to the testimony of today's witness and yield back the balance of my time.

1133 Westchester Avenue
White Plains, NY 10604
April 14, 2005

The Honorable Jon Porter (R-NV)
Chairman
House Government Reform Subcommittee on the Federal Workforce and Agency Organization
US House of Representatives
B-373A Rayburn House Office Building
Washington, DC 20515

Chairman Porter:

IBM is pleased to respond to the Committee's interest in our perspective on REITs. We debated the question of adding REITs to our 401(k) for several years before proceeding with them two years ago.

The IBM Savings Plan is the largest 401(k), with $25 billion in assets, a quarter-million participants, and an average balance of $100,000. We are focused on keeping costs very low, and while our Plan costs are higher than TSP's because of our smaller size, our Plan is run at an all-in cost of below 0.15%, extremely low by any other standard.

Our Plan's first tier offers four "life strategy" funds. These are balanced (multi-asset class) funds, which are blended at four different risk levels from the six broad market, or "core", index funds in our second tier. These six funds are US bonds, inflation-protected bonds, stable value (bonds), US stocks, nonUS stocks, and REITs. REITs were added as the sixth and last core fund for use in blending the life strategy funds two years ago, and offered as a stand-alone fund a year ago.

The third tier is 13 narrower funds for participants that want more choice, e.g. small US growth stocks, unhedged European stocks, etc. A few months ago we added a small mutual fund window, for a fee, for participants who feel the need for even more choice.

Benefits of REITs to the IBM Savings Plan:

- REITs represent an investment window into the multi-trillion dollar commercial real estate market that is mostly privately owned and thus not well-represented in broad stock market indices.
- Daily liquidity (required for daily-traded 401(k) environment)
- REIT prices move more smoothly than most real estate investments which are often priced by appraisal.
- Less expensive than direct investment in private real estate
- Returns and volatility have been slightly superior to the S&P over the past 30+ years. Past performance is of course no indication of the future, but we think it likely that REITs will continue to offer competitive returns and volatility in the long-term.
- Good diversification vs. other investments, even for homeowners (more on this, next page). Long-term, REITs have diversified well against US stocks, nonUS stocks, and bonds. As REITs began to mature about a decade ago with a significant increase in their total market capitalization, their returns became less and less correlated with general equity markets. REITs are increasingly viewed as a separate asset class, rather than as just a small part of the overall stock market.
- While recent volatility has been higher, long-term REIT volatility is expected to be lower than that of the broad equity market, reflecting the "anchoring" effect of REIT dividends in total return. At 5%, REIT dividends are currently 2½ times higher than US stock dividends, and they have grown at a faster rate and in a more stable fashion as well.
- From a Plan design perspective, we also consider tax efficiency. REIT dividends are subject to ordinary income taxes, which makes them a good investment for defined contribution plans where taxes are deferred for many years. It is not just "asset allocation" – it is "asset location". Our participants can invest their tax-deferred money in investments like REITs with higher yields and defer taxes, while investing after-tax money in lower-yielding investments like US stocks, reaping the benefits of lower capital gains taxes.

Arguments Against REITs and IBM's Responses:

- "US stock offerings already include REITs": The S&P does have a very small weight in REITs and real estate development (0.6%), but this represents a very small part of total commercial real estate, and this, as well as the power of expected REIT diversification, led us to conclude that this wasn't a show-stopper.
- "A large proportion of our participants already have a large part of their personal net worth in their own homes and do not need additional real estate investment opportunities": The historical correlation between REITs and home prices is surprisingly low, and we took the view that REIT return, volatility, correlation, and liquidity arguments outweighed this concern.
- "Too many offerings confuse participants": This was one reason we waited until last year to offer REITs as a stand-alone offering. We ultimately assessed the risk as worthwhile, and added REITs as a building block in our life strategy fund construction and as one of our six "core" offerings.
- A current concern might be that "REIT returns were very high in 2003 and 2004", and higher valuations could of course mean lower future yields. Furthermore, bond yields have crept higher, reducing REITs' competitive yield advantage over bonds. Real estate fundamentals do seem to be improving, with vacancy rates edging lower and pricing firming, but we stay away from making timing calls. The decision to add REITs was a long-term decision, and we encourage our participants to make their decisions on a long-term basis as well.

Implementation

Like TSP, most of the IBM 401(k) offerings are extremely low cost index funds, but we did debate the virtues of active versus passive for REITs. It was a tough decision, because unlike most other asset classes, active REIT managers have generally outperformed the market. But manager excess returns can be volatile and costs are substantially higher, so chose an indexed approach.

We chose the Morgan Stanley REIT index as our benchmark. While in principle we would have preferred the broader NAREIT index, it includes a lot of illiquid REITs which is of particular importance given 401(k) daily trading requirements. It also appeared that portfolio tracking error would have been substantially higher using the NAREIT index as a benchmark.

Our manager selection focused on fees, transaction costs, and tracking error. A key challenge is that REIT indexes assume immediate reinvestment of REIT dividends, which cannot actually be invested until received. With a 5% dividend rate, this needs careful consideration.

We initially offered REITs as components of our four balanced funds, which represent almost $4 billion of our Plan's assets, so this was a major step. While REITs are quite well suited for lower risk balanced funds, we found that they had a role in higher risk ones as well. A year ago we added REITs as a stand-alone core fund.

Conclusion:

We are committed to REITs as a core asset class for defined contribution plans for all the reasons described. Their return, volatility, diversification, dividend yield, and taxation characteristics make the case, and we have seen increased interest in adding them to other companies' defined contribution plans, for the same reasons.

We trust the foregoing discussion is useful to you and wish you well in your deliberations.

Sincerely,

R. L. Vivian
Managing Director

Statement of James W. Sauber, Chairman of the Employee Thrift Advisory Council to the House Sub-Committee on the Federal Workforce and Agency Organization regarding "Real Estate Investment Trusts (REITS): Can They Improve the Thrift Savings Plan?"

April 19, 2005

Thank you to Chairman Jon Porter and to the members of the Sub-Committee for this opportunity to submit a statement for the record of this important hearing on Real Estate Investment Trusts (REITs) and the Thrift Savings Plan (TSP). I regret very much that I could not accept your invitation to testify in person – a prior commitment will prevent me from being in Washington on the day of the hearing.

My name is James Sauber. I am the Director of Research for the National Association of Letter Carriers (NALC), a union which represents 310,000 active and retired letter carriers employed by or retired from the United States Postal Service. At present I also serve as the Chairman of the Employee Thrift Advisory Council (ETAC), the body established by the Federal Employees Retirement System Act (FERSA) of 1986 to give a voice to federal and postal employees in the operations of the TSP. I have been actively involved with the Council since its creation in 1987, first as an aide to its first chairman, former NALC President Vincent Sombrotto, and then as a member of the Council and now as its chairman.

ETAC advises the Federal Retirement Thrift Investment Board of the views and concerns of TSP participants through regularly scheduled meetings with the Executive Director of the Board. ETAC is made up of 15 individuals who are nominated by employee organizations identified in the FERSA statute that represent the federal workforce in all its diversity, from

federal and postal employees and federal managers to senior executives and federal retirees. A list of ETAC members is appended to this statement.

The Thrift Savings Plan is a vital component of federal and postal employees' overall compensation package. Participation in the plan is crucial to the retirement security of federal employees, who also earn a modest defined benefit annuity and Social Security benefits. Thanks to a sound design that utilizes index funds to minimize both transaction costs and political interference with investment decisions, the TSP has proven to be very popular with federal and postal employees. Many agencies report TSP participation rates in excess of 85% among FERS-covered employees. My union, the NALC, is proud to report that 95% of letter carriers who participate in the TSP contribute at least five percent of their salaries. Greater than half contribute 10 percent or more.

I emphasize the popularity of the TSP at the outset to underline my primary advice to you: please exercise caution when contemplating major changes in this very successful benefit program. I believe the TSP to be one of the government's best tools to attract and retain excellent workers to serve the country in public service. With that introduction, I am happy to address the central question posed by this hearing: Can Real Estate Investment Trusts improve the Thrift Savings Plan?

I should start by making it clear that the Employee Thrift Advisory Council has not taken a position on this question and that the views expressed in this statement are mine alone, not those of the Council. Indeed, the Council has not yet discussed the recently proposed "Real Estate Investment for Thrift Savings Act." We plan to do so at our next scheduled meeting on May 4, 2005. At this point I think it is safe to say that, like many members of this Sub-Committee, many members of the ETAC are interested in gathering as much information as possible before making a judgment. That's why we welcome this hearing. We hope to learn more about the pros and cons of a REIT option.

Of course, I am aware that the National Association of Real Estate Investment Trusts has advocated a REIT option in the TSP. In fact, last year my union invited the NAREIT to make a presentation on the issue for interested officers and staff. And earlier this year, I arranged for a similar presentation for a number of other federal and postal employee organizations that expressed interest in learning more about REITs. Many members of ETAC have therefore heard the case for adding a REIT fund.

In the May meeting of ETAC, we want to discuss the Federal Thrift Investment Board's views on the REIT fund option. We are aware that the Board has expressed some reluctance to go forward with a REIT fund at

this time. My colleagues and I are interested in exploring the Board's reasons for this stance.

As chairman of ETAC, I see my role as facilitating an informed discussion of matters affecting the TSP. That is how I will approach the REIT issue. In so doing, I plan to make a number of suggestions on how I think the Board and the members of ETAC should handle this issue. In particular, I plan to make two general recommendations and pose three specific questions about the REIT fund option that I believe must be answered before a decision can be made on the merits.

First, as a general matter, I think it is important for policymakers such as the members of this Sub-Committee and members of the Federal Retirement Thrift Investment Board to consider the full range of new fund options before coming to any conclusion about any specific fund like the REIT index fund. Although the existing TSP funds clearly provide a comprehensive cross section of the financial marketplace (including REITS), there are sure to be other possibilities besides a dedicated REIT fund. I am particularly interested in considering inflation-indexed bonds, for example. Before deciding what kind of fund to add to the TSP, we should first consider all the possibilities.

A second general concern that I will raise with the Advisory Council has to do with the possible downside of adding additional funds. At a time when the FRTIB is preparing to add lifecycle funds (options comprised of varying proportions of the existing five funds), do we risk sacrificing one of the TSP's greatest virtues by adding yet another fund: namely, its simplicity.

While there is nothing magical about the number five (or six, after the addition of the L Fund set of options), placing some limit on the number of funds makes sense. Having a simple, understandable set of options for the TSP has clearly helped boost participation rates. Research concerning private sector 401(k) plans has shown that too many choices can cause participation rates to flag and that a common complaint among participants about their 401(k)s is that the plans offer too many investment options. Quite frankly, workers get confused when faced with too many investment choices. This confusion, and the absence of automatic enrollment in most private sector plans (similar to that which exists with the TSP), may explain why participation rates in 401(k)s are generally much lower than that observed for the TSP. Too many funds can also raise administrative costs beyond the added benefit of additional choices.

If adding funds could reduce participation rates and raise costs, it might be worthwhile to ask ourselves: What is the optimum number of investment options for the TSP? My own sense is we might add one or two additional

funds before we reach a point of diminishing returns. Others might argue that we have already passed that point or that we can safely add even more. Whatever the case may be, I think it is important for us to set an upper limit on the number of funds before we decide whether to use one of the limited "slots" available to add a REIT fund or any other specific fund to the TSP.

Beyond, these general points, I also plan to raise three specific sets of questions about the proposed REIT fund with my colleagues on the Council:

- **Would adding a REIT fund represent a departure from the basic plan design envisioned by the FERSA act? Namely, would a fund dedicated to a fairly narrow sector of the economy – commercial real estate – contravene the spirit of FERSA, which limited the TSP's private sector investments to broad index funds that cut across all the major sectors of the economy? If so, would it set a dangerous precedent? Would other sector interests line up at Congress' door asking to be given equal treatment?**

- **How would adding a REIT Fund -- the R Fund – affect the administrative costs of the overall TSP? Although we might expect the TSP to obtain management services at a lower cost than that observed for smaller, private sector plans (given its superior track**

record with the existing index funds), how would the fees charged to run the R Fund compare to those charged to run the existing funds?

- And is the REIT market large enough and liquid enough to handle the kind of volume of trading that might potentially arise through a large plan like the TSP? A thinly traded market could raise costs considerably.

I suspect that these are the kind of questions that are likely to be raised by the Sub-Committee in today's hearing and in the deliberations that follow. I look forward to having these and other questions answered.

At this point, and speaking only for myself, I must say that I am somewhat skeptical about the wisdom of adding a REIT fund to the TSP. I remain so for one primary reason: I am not aware of any significant demand for this option by members of the federal workforce. For example, in my own union, I have conducted training seminars on the TSP at our national conventions for years and have never had a question about adding real estate investments to the TSP. The same was not the case with the international and small cap investment options, which the Board eventually added to the TSP in the form of the I and S Funds.

I will, of course, keep an open mind about the proposed legislation as will, I am sure, my colleagues on the Employee Thrift Advisory Council. We will fully discuss the Real Estate Investment for Thrift Savings Act at our May 4 meeting. I can assure you that if the Advisory Council reaches a consensus on the bill, we will share our views with you and the Sub-Committee promptly. Of course, it is possible that some of our organizations will support the proposal and others may not – in which case, a common ETAC position will not be possible. Regardless, it is my hope that the Employee Thrift Advisory Council can play a constructive role in the debate over this legislation.

Thank you again for the opportunity to participate in this hearing.

QUESTIONS FOR THE RECORD

"Real Estate Investment Trusts (REITS): Can They Improve the Thrift Savings Plan?"
Subcommittee on the Federal Workforce and Agency Organization
Chairman Jon C. Porter
May 1, 2005

The Honorable Andrew M. Saul, Chairman, Federal Retirement Thrift Investment Board

Gary A. Amelio, Executive Director, Federal Retirement Thrift Investment Board

Andrew Saul and Gary Amelio

- During the hearing, you both committed the TSP Board's resources to conducting a thorough examination of all possible additions to the Thrift Savings Plan. When will this study be made available to this Subcommittee?
    - Since you've rejected REITs before the examination has even begun, what assurances can you give to this Committee that your investigation will be conducted in a full and fair manner to all options?

Andrew Saul

- According to IBM, which has a REIT option in its 401(k) plan, long-term REITs have diversified well against U.S. stocks, non-U.S. stocks and bonds. Don't you agree that it would be beneficial to TSP plan participants to have access to an option with such capacity for diversification?

- Do you believe, outside of the Thrift Savings Plan, that real estate investment trusts (REITs) are prudent investment options that help people increase their wealth and diversify their portfolios?

- According to IBM's testimony-for-the-record, the company's "all-in" costs for its 401(k) pension plan are 15 basis points. While the IBM plan is the largest private 401(k) plan in the nation, it is not nearly as large as the Thrift Savings Plan. How is it possible that IBM can offer a cost-conscious REIT option to its employees, but the Thrift Savings Plan cannot?
    - In your mind, is there a fundamental difference between this large, private-sector 401(k) plan and the Thrift Savings Plan?
    - Are you aware that Barclays Global Investors, the same company that administers most TSP funds, also administers the REIT fund for IBM?

- Do you foresee any circumstances under which the Board may eventually reverse itself and decide to add a REIT option to the choices in the TSP?

Gary Amelio

- In your white paper to the Subcommittee, you recognize that many investment analysts recommend a REIT allocation of anywhere between 2-10%. Yet, even though REITs are currently a small portion of both the C and S Funds, it is nearly impossible to have a REIT allocation of over 4% with a proper allocation to the current TSP funds. Does it concern you that on the one hand we all acknowledge that a proper REIT allocation is important, but on the other hand we don't supply Federal employees with the means to get there?
    - Currently, it is my understanding that to achieve an allocation to REITs of 5% a participant would have to place 75% of his/her money into the S Fund. Do you think that such an allocation would be wise for the average TSP participant?
- You have raised cost as a main issue of concern in regards to adding a REIT to the TSP. Is it your assumption that if a REIT were added to the TSP it would not be possible to generate any returns at all because of costs?
    - Specifically what cost considerations would a REIT have to meet before you would consider it appropriate for the TSP, if any?
- As you know, an analysis completed by Ibbotson Associates has demonstrated that adding a REIT fund to the TSP could have demonstrable benefits to Federal employees by increasing returns and lowering risks. In your response to the Subcommittee, you state that one reason you disagree with the analysis is because the report is accompanied by the disclaimer that "past performance is no guarantee of future results." Isn't a disclaimer like this attached to nearly all investment analysis?
    - Do you believe that such a disclaimer disqualifies the Ibbotson report from serious consideration?
- In your testimony, you characterize REITs as a "narrow, industry-specific product." Many other investment companies, including Barclays Global Investors and IBM, have characterized REITs rather as a separate asset class entirely. Would you please explain why you believe that REITs are simply an industry-specific product rather than, as Barclays has stated, a separate asset class?
    - Do you believe that REITs are a separate asset class from the other investments in the TSP?
    - How would you define an asset class?
    - Please explain how a REIT does or does not fit into that definition.
- It is my understanding that in a 30-year comparison, the REITs have produced higher rates of return than the S&P 500 with less volatility. Would you agree that it would be beneficial to TSP participants to add a fund with higher returns and less volatility?

- Does the Board's reluctance to support REITs stem from concerns over the high workload it has in unveiling Lifecycle funds? If so, please explain.

QUESTIONS FOR THE RECORD

"Real Estate Investment Trusts (REITS): Can They Improve the Thrift Savings Plan?"

Subcommittee on the Federal Workforce and Agency Organization
Chairman Jon C. Porter
May 1, 2005

Steven A. Wechsler, President and CEO, National Association of Real Estate Investment Trusts
Amy Schioldager, Managing Director, U.S. Indexing Products, Barclays Global Investors
Dr. Roger G. Ibbotson, Chairman, Ibbotson Associates

Steven Wechsler

- Why should we add a REIT stock to the TSP when REITs are already represented in the C and S Funds?
- How do you respond to the Board's assertion that adding a REIT option at this time would confuse TSP participants?
    - How have employees reacted in private sector plans that have added REITs to their 401(k) plans?

Amy Schioldager

- Do you believe that it would be possible to administer a REIT fund in the TSP that is cost-conscious and produces a competitive return on investment?
- As REITs are a growing investment vehicle in recent years, would you anticipate that as the market capitalization for REITs grows, the transaction costs associated with them will decrease?
- Is there a fundamental reason why a REIT fund would be acceptable within IBM's 401(k) plan, but would not be within the Thrift Savings Plan?
- There has been some dispute lately as to whether REITs are a separate asset class or just the security offered from one segment of the market. In your testimony, you state that REITs are, in fact, a distinct asset class. Can you explain why you have classified REITs as a distinct asset class?

Roger Ibbotson

- As a professor of finance at Yale University, and Chairman of an investment analysis company, you've had plenty of exposure to many kinds of investment vehicles. Do you see REITs as a strong investment option currently, as well as in the coming years?

- In your extensive analysis of the behavior of a REIT within the TSP, is it your conclusion that had a REIT option been available to employees since the creation of the plan that they would be better off?
    - Do you believe that adding a REIT option to the TSP will make employees better off in the next 10, 20, 30 years?
- In your report, which analyzed the impact of a REIT fund within the Thrift Savings Plan, you draw the conclusion that adding a REIT index fund would "increase returns and lower risks" for TSP participants. Would you explain how it is that a REIT fund could provide this kind of a benefit to Federal employees?
- In a white paper that the Board has supplied to members of the press, they level heavy criticisms at your analysis of the impact of REITs in the TSP. The Board asserts that your "analysis is not sound basis for investment policy" and that it is based "on unreasonable expectations." Since your report provides extensive analytical evidence that a REIT would benefit the TSP, can you defend the methods used and conclusions reached by your analysts?
- The Board's concerns about REITs are over perceived high costs and potentially low liquidity in the REIT market. Are the Board's concerns justified or is it possible to overcome these issues if a REIT were added to the TSP?
    - What cost estimates did you use when considering how a REIT would perform in the TSP? How do your estimates compare to the TSP's actual costs?
    - Is it your belief that a REIT fund would incur such high expenses within the TSP as to reduce the possibility of returns?
- The Board has challenged your report's accuracy in describing the benefits of REITs by stating that your analysis depends upon a 40% allocation to REITs. Do you believe that REITs would benefit a TSP portfolio if employees allocated only 5-10% of their money to REITs?
- Do you agree with the Board's characterization of REITs as the "security of one industry?"

What do you think is the most accurate characterization of REITs: the security of one industry or a separate asset class?

FEDERAL RETIREMENT THRIFT INVESTMENT BOARD
1250 H Street, NW Washington, DC 20005

GARY A. AMELIO
Executive Director

May 17, 2005

The Honorable Jon C. Porter
Chairman, House Subcommittee on the Federal Workforce
and Agency Organization
Washington, D.C. 20515

Dear Chairman Porter:

Attached are our responses to questions for the record transmitted by your Subcommittee on May 1, 2005.

We would also like to express on the record our deep concern that the recent actions by the Subcommittee have generated negative press stories (see attached from the National Journal and Wall Street Journal) and responses from members of the statutory Employee Thrift Advisory Council (see attached meeting transcript) concerning political manipulation of Thrift Savings Plan investments.

The conference report on the TSP enabling legislation states the following:

> A great deal of concern was raised about the possibility of political manipulation of large pools of Thrift Plan money. This legislation was designed to preclude that possibility.
>
> Concerns over the specter of political involvement in the Thrift Plan management seem to focus on two distinct issues. One, the Board, composed of Presidential appointees, could be susceptible to pressure from the Administration. Two, the Congress might be tempted to use the large pool of thrift money for political purposes. [Emphasis added.]

The statutory design which precludes the possibility of political manipulation is a uniquely independent Thrift Investment Board and Executive Director who, as fiduciaries, must act solely in the interest of plan participants and beneficiaries. Those participants and beneficiaries deserve to know that this Board and Executive Director intend to do just that.

Very truly yours

Andrew M. Saul
Chairman

Gary A. Amelio
Executive Director

Enclosures

ANSWERS TO QUESTIONS FOR THE RECORD FROM CHAIRMAN JON C. PORTER
REAL ESTATE INVESTMENT TRUSTS (REITS): CAN THEY IMPROVE THE THRIFT SAVINGS PLAN
COMMITTEE ON GOVERNMENT REFORM
SUBCOMMITTEE ON THE FEDERAL WORKFORCE AND AGENCY ORGANIZATION
APRIL 19, 2005

Questions for both Mr. Saul and Mr. Amelio

Question 1. During the hearing, you both committed the TSP Board's resources to conducting a thorough examination of all possible additions to the Thrift Savings Plan. When will this study be made available to this Subcommittee?

Answer: As explained on page 4 of Chairman Saul's testimony, the Board's plan is to install the Lifecycle Funds in the TSP, evaluate the impact of the TSP's education efforts and the new funds on participant behavior (followed by a participant survey), and evaluate other potential funds/asset classes along with the existing offerings. Regarding the notion that we "committed the TSP Board's resources," please be aware that the Board receives no annual appropriations from the Congress. There are no resources available to the Board other than Plan funds which belong to TSP participants. In all cases, decisions to expend or not expend these resources, as well as the timing of expending "Board" (i.e., participants') resources, are made by the fiduciaries solely in the interest of Plan participants as the law requires.

We did state firmly that investment policy should not be developed one fund at a time on a case-by-case basis. Sound investment policies can only be developed in a comprehensive fashion.

The Board has a statutory obligation to "establish" and "develop" TSP investment policies. 5 U.S.C. § 8472(f)(i), § 8475. For the past eighteen years, copies of important Board investment policy decisions have been timely provided to the Congress. The past ten Congresses have found this an appropriate way to oversee Board investment policy activities while keeping them separate from the political interests which exist in the Congressional environment. We intend to continue this successful approach.

Question 1A. Since you've rejected REITs before the examination has ever begun, what assurances can you give this Committee that your investigation will be conducted in a full and fair manner to all options?

Answer: We "rejected REITs" in Executive Director Amelio's January 18 letter to the Subcommittee in response to a direct request from the Subcommittee for our views. As that letter further states, "the professional staff will continue to examine potential investments (as it has done for the past 15 years) and report promising developments to the Executive Director and the members of the Board. These analyses will include REITs as well as other possible investments as discussed in the enclosed [white] paper. Potential investments will be pursued based on compelling evidence and convincing analysis."

Questions for Mr. Saul

Question 2. According to IBM, which has a REIT option in its 401(k) plan, long-term REITs have diversified well against U.S. stocks, non-U.S. stocks and bonds. Don't you agree that it would be beneficial to TSP plan participants to have access to an option with such capacity for diversification?

Answer: Our views regarding REITs are discussed in detail in our testimony and the January 18, 2005, letter to the Subcommittee. This does not mean that IBM, which offers 21 investment choices to its employees, including REITs, is "wrong" or that we are "right." Fiduciaries for every plan should develop an investment policy based on any number of issues related to that particular plan and the participants it serves. One additional matter that the Board must consider (while others do not) is the TSP's enabling legislation.

IBM has pursued the "many fund" approach. Thus, participants in that plan may diversify their investments by selecting a group from the many choices offered. Under the approach statutorily established for the TSP, the diversification occurs within the small group of broad indexes. As noted in my testimony, TSP participants already have $1.1 billion invested in REITs in the broadly diversified TSP funds. REITs were first offered to TSP investors in 2001. Since then, their weight has tripled in the C Fund and nearly doubled in the S Fund. The Plan's fiduciaries unanimously believe the approach in our statute is correct for the TSP.

Question 3. Do you believe, outside of the Thrift Savings Plan, that real estate investment trust (REITs) are prudent investment options that help people increase their wealth and diversify their portfolios?

Answer: The Board has not expressed a view on investments outside of the TSP. The Plan fiduciaries continue to believe that is the appropriate approach.

Question 4. According to IBM's testimony-for-the-record, the company's "all-in costs for its 401(k) pension plan are 15 basis points. While the IBM plan is the largest private 401(k) plan in the nation, it is not nearly as large as the Thrift Savings Plan. How is it possible that IBM can offer a cost-conscious REIT option to its employees, but the Thrift Savings Plan cannot?

Answer: The Board has no comment or position regarding the IBM plan. We note, however, that 15 basis points is 2 ½ times **more expensive** than the TSP's current 6 basis point expense ratio. If REIT fund expenses were 15 basis points, money invested in that fund would have an expense ratio of 21 basis points (6bp + 15bp), an expense ratio almost four times that charged to investors in the current TSP funds. Additionally, as explained in the attached news item from the July 25, 2004, Sun Sentinel, many IBM employees found themselves "overwhelmed" by their plan and felt the need to pay an additional fee for investment advice. This fee added almost 50 basis points of expense for those employees, bringing their annual expenses to about 65 basis points, over 10 times the cost of the TSP. Costs incurred by participants significantly reduce the account balance available upon withdrawal.

Question 4A. In your mind, is there a fundamental difference between this large, private-sector 401(k) plan and the Thrift Savings Plan?

Answer: The TSP operates like any 401(k) plan. However, in designing the TSP, Congress (on two separate occasions) legislated broadly diversified index funds. The legislative history clearly reflects that this was intentionally done to insulate the Federal plan from political pressure from any Congress or Administration (which of course would not be an issue for IBM or other private plans).

Question 4B. Are you aware that Barclays Global Investors, the same company that administers most TSP funds, also administers the REIT fund for IBM?

Answer: Yes.

Question 5. Do you foresee any circumstances under which the Board may eventually reverse itself and decide to add a REIT option in the choices in the TSP.

Answer: The view expressed on this matter in prior testimony and today is shared by the Board, the Executive Director, the professional staff, the Agency's asset allocation consultant, and the Board's fiduciary trainer. However, that position could change over time. The Agency intends to obtain additional information and conduct careful and ongoing analysis. We are especially interested in any data the industry has collected on investments in other participant-directed, daily-valued defined contribution plans with a large and diverse participant base.

Questions for Mr. Amelio:

Question 6. In your white paper to the Subcommittee, you recognize that many investment analysts recommend a REIT allocation anywhere between 2-10 percent. Yet, even though REITs are currently a small portion of the C and S Funds, it is nearly impossible to have a REIT allocation of over 4 percent with a proper allocation in the current TSP funds. Does it concern you that on one hand we all acknowledge a proper REIT allocation is important, but on the other hand we don't supply Federal employees with the means to get there?

Answer: The white paper that was developed in response to the Subcommittee's request of November 22, 2004, discusses the research conducted by Ibbotson Associates, the firm retained by NAREIT. We cited that research as determining that, "At risk levels between 2 percent and 10 percent, the allocation to REITs varied from 6 percent to 17 percent." Thus, the premise of the question misconstrues the white paper.

In 2000, TSP investments included no REITs. The Board chose the Dow Jones Wilshire 4500 completion stock index for the S Fund, which included REITs, and it was offered for the first time in 2001. In 2002, REITs had grown to 4 percent of the S Fund; in 2005, REITs have grown to 8.5 percent of the S Fund. Thus, this program is operating exactly the way the 99th Congress designed

it. As noted in the Joint Explanatory Statement of the Committee of Conference for the TSP's enabling legislation "...the actual decision to buy or sell a given stock is determined by the market place, i.e., the ratio of values of stock within the index. As the relative values change, the investments from the fund change. Hence no individual or group of individuals are capable of manipulating investments." The statute provides for the dynamic, broadly diversified funds that have served TSP participants well.

Question 6A. Currently, it is my understanding that to achieve an allocation of REITs of 5 percent a participant would have to place 75 percent of his or her money into the S Fund. Do you think that such an allocation would be wise for the average TSP participants?

Answer: A participant should be concerned with an overall asset allocation strategy, and should not be driven by one sector.

Question 7. You have raised cost as a main issue of concern in regards to adding a REIT to the TSP. Is it your assumption that if a REIT were added to the TSP it would not be possible to generate any returns at all because of the costs?

Answer: Cost considerations are always relevant, insofar as transactions costs and management fees reduce investment returns. Unusual costs related to a particular type of investment must be considered in attempting to understand the marginal benefit of including that investment in the portfolio. REIT costs would need to be in line with the five existing TSP fund options to make it an attractive option for participants.

Question 7A. Specifically, what cost considerations would a REIT have to meet before you would consider it appropriate for the TSP, if any?

Answer: Please see answer 7 above.

Question 8. As you know, an analysis completed by Ibbotson Associates has demonstrated that adding a REIT fund to the TSP could have demonstrable benefits to Federal employees by increasing returns and lowering risks. In your response to the Subcommittee, you state that one reason you disagree with the analysis is because the report is accompanied by the disclaimer that "past performance is no guarantee of future results."

Isn't a disclaimer like this attached to nearly all investment analysis?

Answer: Such disclaimers are ordinarily contained in investment materials and serve as a reminder to the reader that historical data is not always the best basis for one's expectations regarding future performance; nor are the past results promised by the author. Investment policy must be based on one's reasonable expectations regarding the future, not on past performance. As we showed in our white paper, the returns cited by Ibbotson could only have been achieved if an investor had invested at exactly the time REITs performed the best (i.e, using perfect hindsight), had put about 40% of his or her account into REITs (an allocation that no expert would recommend now or would have recommended at the time), and had invested in the NAREIT index (which institutional investors do not use due to the illiquidity of many of the components of the index). Pursuit of a more supportable investment strategy, using an investible REIT index and investing reasonable percentages in that index, would have yielded far more modest returns.

Question 8A. Do you believe such a disclaimer disqualifies the Ibbotson report from serious consideration?

Answer: Please see answer 8 above.

Question 9. In your testimony, you characterize REITs as a "narrow, industry-specific product." Many other investment companies, including Barclays Global Investors and IBM, have characterized REITs rather as a separate asset class entirely. Would you please explain why you believe that REITs are simply an industry-specific product rather than, as Barclays has stated, a separate asset class?

Answer: An asset class is a type of investment, such as bonds, equities, real estate, or cash. We believe that REITs are equities, as evidenced by their inclusion in the equity indexes; and it is our understanding that BGI also regards REIT securities to be equities and, as such, appropriate for inclusion in the TSP's stock index funds. However, real estate is a separate asset class, and REITs are a good proxy for real estate; that is, returns from investment in REITs are statistically similar to direct investment in real estate. Real Estate Investment Trusts (REITs) are corporations or trusts that use the pooled capital of many investors to purchase and manage income property (equity REITs) and/or mortgage loans (mortgage

REITs). REITs derive their value from holdings in real estate, but they are not real estate.

Mike Miles, a Certified Financial Planner and respected financial writer whose column appears in the Federal Times and is read by thousands of Federal employees, addresses the issue this way: "...the value of REITs as a distinct asset class is widely debated. Real estate ownership, operation and financing are integral parts of the U.S. business economy and are already represented in the TSP's current index fund offerings. When you own the C Fund, for example, you own real estate and real estate-related business. Rather than a unique asset class, in my view and in the view of many others, real estate is more accurately a subsector of the broader equity and debt markets - an industry. So offering a REIT fund is similar in concept to offering a separate technology, health care or financial services fund."

Question 9A. Do you believe that REITs are a separate asset class from the other investments in the TSP?

Answer: Please see answer 9 above.

Question 9B. How would you define an asset class?

Answer: Please see answer 9 above.

Question 9C. Please explain how a REIT does or does not fit into that definition?

Answer: Please see answer 9 above.

Question 10. It is my understanding that in a 30-year comparison, the REITs have produced higher rates of return than the S&P 500 with less volatility. Would you agree that it would be beneficial to TSP participants to add a fund with higher returns and less volatility?

Answer: The 30-year comparison of REITs to the S&P 500 was based on the NAREIT Equity REIT Index. Investment managers, however, do not manage to this index. Historical data for other REIT indexes relative to the S&P 500 have shown lower returns and less volatility. You should also recall the discussion in question 8 above, that "past performance is no guarantee for future results."

Question 11. Does the Board's reluctance to support REITs stem from concerns over the high workload it has in unveiling Lifecycle funds? If so, please explain.

Answer. As explained at length in our testimony, the number one issue for TSP investors at this time is not additional funds but proper allocation among the existing funds.

Attachment

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NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

May 13, 2005

The Honorable Jon C. Porter
Chairman
House Government Reform Subcommittee on the Federal Workforce and Agency Organization
US House of Representatives
B-373 A Rayburn House Office Building
Washington, DC 20515

Dear Chairman Porter:

Thank you for holding the hearing in the Subcommittee on the Federal Workforce and Agency Organization on H.R. 1578, the Real Estate Investment Thrift Savings (REITS) Act and for allowing me to participate as a panel witness. I appreciate the ongoing dialogue the Committee has had with the National Association of Real Estate Investment Trusts (NAREIT) on this issue and thank you for the opportunity to answer the following questions you have posed to me in writing.

- **Why should we add a REIT stock [index fund] to the TSP when REITs are already represented in the C and S Funds?**

It is important to note that the Ibbotson Associates analysis cited in my written testimony dated April 19, 2005 fully accounts for the exposure to REIT stocks already available to TSP participants through the C fund and the S fund. Any duplication is of no consequence for the historical analyses developed by Ibbotson, as all duplication is reflected in the performance record of these two funds.

Moreover, the Ibbotson Associates analysis, the Morningstar® retirement guide and major institutional portfolios, including the General Motors defined benefit plan, all include a targeted allocation of at least 5-10 percent to income producing real estate investment, including REITs, in order to achieve a meaningful and appropriate amount of portfolio diversification. In all these applications of modern portfolio theory, the critical issue is not whether the real estate allocation nominally is referred to as an "industry" allocation or an "asset class" allocation. Rather, the critical issue is whether a real estate allocation adds appreciable diversification benefits to the overall portfolio and what percentage allocation is required in order to achieve those benefits.

♦♦♦

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The TSP's C fund tracks the Standard & Poor's 500 Stock Index, while the S fund tracks the Dow Jones Wilshire 4500 Completion Index. As shown in Exhibit 13 of my written testimony, the S&P 500 Stock Index included 7 REIT stocks as of March 31, 2005. These 7 stocks combined had a market weight in the S&P 500 of 0.53 percent. The Dow Jones Wilshire 4500 Completion Index included 186 REITs with a combined market weight of 6.31 percent. There also are a few non-REIT real estate companies represented in the S Fund, which raises the real estate exposure to about 7 percent. However, these non-REITs do not necessarily have the same diversification characteristics as REITs because they are not required to distribute significant dividends. Thus, although some exposure to REIT stocks is embedded in the performance of the C and S funds, this exposure is very small and inadequate to obtain meaningful portfolio diversification.

In particular, a TSP participant either cannot obtain a meaningful REIT allocation by investing only in the C or S funds or can only achieve meaningful exposure to REITs by significantly concentrating his or her investments in one fund, the S fund, thereby violating a cardinal tenet of portfolio diversification. For example, to obtain a 5 percent exposure to REITs in the absence of a distinct REIT index fund, a TSP participant would need to invest approximately 80 percent of his or her total TSP account balance in the S fund. And a 10 percent allocation to REITs could not be achieved using any combination of current TSP investment funds.

Based on balances in the C fund and S fund as of December 31, 2004 and the market value of REIT stocks in these two funds as shown in Exhibit 13, we estimate that TSP participants on the whole have an implied allocation to REITs of approximately $1.0 billion, or less than 0.7 percent. As demonstrated by Ibbotson's analysis, such a limited allocation simply does not provide plan participants with a meaningful or beneficial exposure to commercial real estate, which can only be made available through a separate and distinct REIT index fund.

- **How do you respond to the Board's assertion that adding a REIT option at this time would confuse TSP participants?**

To effectively build a well-diversified retirement portfolio, plan participants require an adequate number of investment funds from which to choose. While there appears to be no consensus regarding the optimum number or type of investment funds, available survey data reveal that there are approximately 16 investment funds (not including lifecycle funds) on average available in defined contribution plans nationwide.

Considering that the TSP today offers its participants only 5 choices, it appears that federal civilian and military employees are among those most limited in their ability to assemble a truly diversified retirement portfolio. We believe that federal civilian and military employees are at least as, if not more than, financially sophisticated as the average private citizen investing in private 401(k) plans and that limiting their diversification options because of concerns about their financial sophistication is both unsound and unwarranted. Moreover, I believe that federal employees, as employees generally nationwide, would welcome additional and appropriate educational materials to more effectively guide their investment decisions.

♦ ♦ ♦

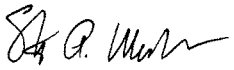
- **How have employees reacted in private sector plans that have added REITs to their 401(k) plans?**

Data for participation rates by number of participants at private sector defined contribution plans are not readily available. However, the Profit Sharing/401(k) Council of America publishes annual survey data pertaining to the proportions of different types of investment funds, including real estate funds, which comprise the investment lineups offered by profit sharing and 401(k) plans. The proportion of all plans offering a real estate fund for participant contributions has risen sharply from around 5 percent of all plans in the late 1990s to nearly 12 percent in 2003. Further, data from the latest Pensions & Investments Top 1,000 Plan Sponsors Survey show that four of the six largest 401(k) plans offer a REIT option to their participants.

PSCA survey data for the 2003 plan year showed that participants in plans offering a real estate fund as part of their investment lineup had allocated 3.6 percent of their total invested assets to the real estate fund, a result not unlike the participation rates for the S Fund and the I Fund as of December 31, 2003.

Again, I thank you for all of your efforts on H.R. 1578, the REITS Act, and for the opportunity to answer your Subcommittee's questions. Please do not hesitate to contact us if you would like additional information.

Sincerely,



Steven A. Wechsler
President and CEO
National Association of Real Estate Investment Trusts

IbbotsonAssociates

May 13, 2005

The Honorable Jon C. Porter
Chairman
House Government Reform Subcommittee on the Federal Workforce and Agency Organization
US House of Representatives
B-373 A Rayburn House Office Building
Washington, DC 20515

Dear Chairman Porter:

Thank you for allowing me to participate as a panel witness in the hearing of the Subcommittee on the Federal Workforce and Agency Organization on H.R. 1578, the Real Estate Investment Thrift Savings (REITS) Act. Below you will find my answers to the questions that were posed to me.

- **As a professor of finance at Yale University, and Chairman of an investment analysis company, you've had plenty of exposure to many kinds of investment vehicles. Do you see REITs as a strong investment option currently, as well as in the coming years?**

REITs have historically been a strong investment option—both from a performance standpoint as well as from a diversification standpoint. Going forward we cannot guarantee that the returns of REITs will be as high as past returns, but REITs will still offer excellent diversification to the TSP's stock and bond portfolios.

- **In your extensive analysis of the behavior of a REIT within the TSP, is it your conclusion that had a REIT option been available to employees since the creation of the plan that they would be better off?**

Yes, had a REIT option been available to TSP participants, they would have been better off. REITs have historically offered higher returns than those of the other equity funds in the TSP program and did so with less risk (measured by standard deviation).

  - **Do you believe that adding a REIT option to the TSP will make employees better off in the next 10, 20, 30 years?**

Yes, I believe adding a REIT option will make TSP participants better off in the next 10, 20, 30 years. This is primarily due to the diversification benefits offered by adding REITs to the program. We do not know how high the returns of REITs will be going forward. In one section of our analysis we examined the return of the REIT index fund with lower returns than their historical returns in a series of "what if" scenarios, commonly referred to as sensitivity analysis

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(this is discussed in greater detail below). Even after the lowered return adjustments were applied, REITs still appeared in 88% of the historical optimal portfolios.

- **In your report, which analyzed the impact of a REIT fund within the Thrift Savings Plan, you draw the conclusion that adding a REIT index fund would have "increased returns and lowered risks" for TSP participants. Would you explain how it is that a REIT fund could provide this kind of a benefit to Federal employees?**

The addition of a REIT index fund would have increased returns and lowered risks primarily due to REITs high historical returns and the low historical correlation between the REIT index fund and the other equity funds in the TSP program. The cross-correlation between two funds measures the extent to which they move in relation to one another. Low to moderate correlation coefficients are favored by mean-variance optimization as opposed to high correlations (as one fund moves in one direction the other fund has historically moved in the same direction). The low correlations of REITs provide excellent diversification to federal employees when combined with the other funds of the TSP program.

- **In a white paper that the Board has supplied to members of the press, they level heavy criticisms at your analysis of the impact of REITs in the TSP. The Board asserts that your "analysis is not sound basis for investment policy" and that it is based "on unreasonable expectations." Since your report provides extensive analytical evidence that a REIT would benefit the TSP, can you defend the methods used and conclusions reached by your analysts?**

Yes, I can defend the methods used and the conclusions reached by my analysts.

The analysis was based on mean-variance optimization, which was pioneered by Nobel Laureate Harry M. Markowitz. Markowitz optimization requires only three inputs: the expected return of each asset, the standard deviation of the returns (risk), and the correlation between asset returns. The expected returns were based upon the historical results of REITs over the period 1988 to 2004. The measures of risk and correlation with the other funds were also based upon the historical period.

We also examined various scenarios in which the future returns of the TSP funds would be the same as their historical returns, but the REIT returns were unfavoably adjusted so that either their returns would be lower, their risk would be higher, or they would offer less diversification benefits than they did historically. Rather than arbitrarily making adjustments to the R Fund's return, risk, and correlation, they were made in relation to the C Fund. The objective of the C Fund is to match the performance of the S&P 500 Index, a broad market index made up of stocks of 500 large- to medium-size U.S. companies. The adjustments applied included:

1. decreasing the R Fund's return so that it was 90%, 80%, and 70% of the C Fund's historical return, with standard deviation and correlations remaining at historical levels,
2. increasing R Fund's standard deviation (risk) so that it was 100%, 110%, and 120% of the C Fund's historical standard deviation, with return and correlations remaining at historical levels,
3. increasing the correlation (and thus reducing the diversification benefit) between the R Fund and the C Fund, with return and standard deviation remaining at historical levels, a
4. decreasing the R Fund's return and standard deviation so that they were 90%, 80%, and 70% of the C Fund's historical return and standard deviation, while keeping correlations at historical levels.

Even after the above adjustments were applied and the optimization was conducted, REITs still appeared in 88% of the optimal portfolios in the various scenarios.

- **The Board's concerns about REITs are over perceived high costs and potentially low liquidity in the REIT market. Are the Board's concerns justified or is it possible to overcome these issues if a REIT were added to the TSP?**

The management expenses of REITs would be somewhat higher than that of the TSP stock funds, but provided that the REITs were managed in an index fund, the expenses would still be quite low. REITs are somewhat less liquid than stocks, but they are by far the most liquid way to invest in real estate. The transaction costs of a REIT TSP fund are likely to be relatively low because the turnover would likely be low. Money withdrawn is likely to be offset by money inflows, so that the REIT fund will probably not have to sell REIT shares very frequently.

  - **What cost estimates did you use when considering how a REIT would perform in the TSP? How do your estimates compare to the TSP's actual costs?**

Since we did not have historical expenses to work with for the REIT fund, they had to be estimated. The expenses of the REIT fund were based primarily on the actual expenses incurred by the C Fund currently offered through the TSP program. We employed a conservative approach in which we doubled the historical expenses of the C Fund and applied the resulting numbers to the REIT fund.

  - **Is it your belief that a REIT fund would incur such high expenses within the TSP as to reduce the possibility of returns?**

Despite our assumption that REITs would have double the expenses of the C Fund, the REIT fund still occupied a place in the optimal portfolio for a TSP participant.

- **The Board has challenged your report's accuracy in describing the benefits of REITs by stating that your analysis depends upon a 40% allocation to REITs. Do you believe that REITs would benefit a TSP portfolio if employees allocated only 5-10% of their money to REITs?**

My analysis does not depend on a 40% allocation to REITs. If TSP participants would have historically allocated as little as 5% to 10% of their capital to REITs, they still would have benefited due to the reasons discussed earlier. In fact, we would not encourage a 40% allocation to the REIT fund since too heavy a REIT allocation would diminish the diversification potential of REITs when combined with the other TSP funds.

- **Do you agree with the Board's characterization of REITs as the "security of one industry?"**

  What do you think is the most accurate characterization of REITs: the security of one industry or a separate asset class?

An asset class is defined as a grouping of securities with similar characteristics and properties. As a group, these securities will tend to react in a specific way to economic factors. Real estate is an example of an asset class. Its returns behave differently than stocks and bonds, and real estate represents a large part of our nation's wealth. A REIT is the vehicle through which one can invest in such an asset class. Investing in real estate through REITs is advantageous because REITs are much more liquid, and a REIT portfolio can be indexed, so that it is much more inexpensively managed than direct real estate investments.

Sincerely,

Roger G. Ibbotson
Chairman
Ibbotson Associates

QUESTIONS FOR THE RECORD

"Real Estate Investment Trusts (REITS): Can They Improve the Thrift Savings Plan?"
Subcommittee on the Federal Workforce and Agency Organization
Chairman Jon C. Porter
May 1, 2005

Steven A. Wechsler, President and CEO, National Association of Real Estate Investment Trusts
Amy Schioldager, Managing Director, U.S. Indexing Products, Barclays Global Investors
Dr. Roger G. Ibbotson, Chairman, Ibbotson Associates

Steven Wechsler

- Why should we add a REIT stock to the TSP when REITs are already represented in the C and S Funds?

- How do you respond to the Board's assertion that adding a REIT option at this time would confuse TSP participants?

    - How have employees reacted in private sector plans that have added REITs to their 401(k) plans?

Amy Schioldager

- Do you believe that it would be possible to administer a REIT fund in the TSP that is cost-conscious and produces a competitive return on investment?

  Yes, we do believe it is possible to manage a REIT fund in the TSP that achieves the criteria you describe. Our analysis of the REIT marketplace shows that most of the REIT indices have liquidity characteristics similar to the US small-capitalization equity market in which the TSP's current Dow Jones/Wilshire 4500 Index option, the S Fund, invests. We have worked with TSP staff to establish procedures that have cost-effectively managed cash flows in this market since this option was added to the plan in 2001. Assuming that one of the more liquid REIT indexes were selected as the benchmark for a potential new option, we believe that these same procedures would work just as effectively for a REIT index fund option.

- As REITs are a growing investment vehicle in recent years, would you anticipate that as the market capitalization for REITs grows, the transaction costs associated with them will decrease?

  REIT liquidity has improved markedly over the last five years with approximately $1 billion of REITs now changing hands on a daily basis. As popularity of this

asset class grows, all other things being equal, we expect that transaction costs will decrease. However, it is unlikely that transactions costs for REITs will approach costs for very liquid assets, such as large capitalization S&P 500 stocks, in the near term.

- Is there a fundamental reason why a REIT fund would be acceptable within IBM's 401(k) plan, but would not be within the Thrift Savings Plan?

  There are two issues to consider when comparing the Thrift Savings Plan to a large corporate 401(k) plan such as IBM's 401(k) plan.

  The first is the magnitude of daily flows. Given the size of the Thrift Savings Plan, daily cash flows into or out of each of the current investment options can be large relative to the amount that some of the markets can absorb cost effectively. In addition, in a 401(k) plan such as the IBM 401(k) plan, the possibility for large flows is somewhat mitigated by the existence of a larger number of investment options.

  The second point with respect to adding a REIT investment option to the TSP is not whether additional options are a good idea but rather is a REIT option the most appropriate addition. It is our view that there are many asset categories worthy of evaluation, and in our testimony we encouraged the Subcommittee to take a broad view of candidate asset classes when determining if REITs are the most appropriate potential addition. There are indeed others worthy of consideration, such as emerging market equities and TIPs. Before selecting a new investment option, it would be appropriate to analyze the full spectrum of asset class options available, to evaluate their diversification potential and return opportunities, and then to select the most suitable additional option(s).

- There has been some dispute lately as to whether REITs are a separate asset class or just the security offered from one segment of the market. In your testimony, you state that REITs are, in fact, a distinct asset class. Can you explain why you have classified REITs as a distinct asset class?

  It is not the case that we view REITs as a separate asset class, per se, but rather that we view real estate as a separate asset class. It has long been industry practice to view real estate as a standalone asset class due, in large measure, to the diversifying properties real estate has relative to other frequently used asset classes such as US equities. REITs represent an easy way to invest in real estate especially for individual investors and small to mid-size defined benefit plans which lack the asset size to develop a welldiversified, direct real estate portfolio.

Roger Ibbotson

- As a professor of finance at Yale University, and Chairman of an investment analysis company, you've had plenty of exposure to many kinds of investment vehicles. Do you see REITs as a strong investment option currently, as well as in the coming years?

- In your extensive analysis of the behavior of a REIT within the TSP, is it your conclusion that had a REIT option been available to employees since the creation of the plan that they would be better off?
    - Do you believe that adding a REIT option to the TSP will make employees better off in the next 10, 20, 30 years?
- In your report, which analyzed the impact of a REIT fund within the Thrift Savings Plan, you draw the conclusion that adding a REIT index fund would "increase returns and lower risks" for TSP participants. Would you explain how it is that a REIT fund could provide this kind of a benefit to Federal employees?
- In a white paper that the Board has supplied to members of the press, they level heavy criticisms at your analysis of the impact of REITs in the TSP. The Board asserts that your "analysis is not sound basis for investment policy" and that it is based "on unreasonable expectations." Since your report provides extensive analytical evidence that a REIT would benefit the TSP, can you defend the methods used and conclusions reached by your analysts?
- The Board's concerns about REITs are over perceived high costs and potentially low liquidity in the REIT market. Are the Board's concerns justified or is it possible to overcome these issues if a REIT were added to the TSP?
    - What cost estimates did you use when considering how a REIT would perform in the TSP? How do your estimates compare to the TSP's actual costs?
    - Is it your belief that a REIT fund would incur such high expenses within the TSP as to reduce the possibility of returns?
- The Board has challenged your report's accuracy in describing the benefits of REITs by stating that your analysis depends upon a 40% allocation to REITs. Do you believe that REITs would benefit a TSP portfolio if employees allocated only 5-10% of their money to REITs?
- Do you agree with the Board's characterization of REITs as the "security of one industry?"

What do you think is the most accurate characterization of REITs: the security of one industry or a separate asset class?

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