

Private equity may not be as lucrative as it seems

Despite the recent credit market crunch that threatens private equity (PE) firms, the spectacular returns some of them have enjoyed in recent years poses a dilemma for public and union pension funds, which by some accounts supply PE firms with more than a fifth of the new money they raise.

On the one hand, labor and other critics charge that PE acquisitions are little more than a replay of the much-disparaged leveraged buyouts (LBOs) of the 1980s: They use massive debt

to snag a public company, strip assets and slash labor and other costs, then flip it back into the public market for a gargantuan profit.

On the other hand, pension trustees quite properly seek higher returns for their funds. They were prominent among early investors in PE, and many feel that its performance is simply too high to ignore.

Unfortunately, there's scant evidence so far about the overall impact PE has had on corporate performance, jobs, wages, or working conditions. (See labor-friendly article that follows.) However, there's a lot more data out there about the performance of the PE funds themselves, a subject on which new light was shed at the Labor and Worklife Program's fifth annual Capital Matters: Managing Labor's Capital conference.

The conclusion is a whole lot murkier than all the adulatory stories in the press about PE's spectacular successes. Yes, PE buyout funds beat the market in 2006, when they averaged nearly 25% even after the enormous fees they charge vs. about 11% posted by the S&P 500, according to Thompson Corp. data. (See chart on page 2.) However, PE looks less glamorous over the longer term, besting the S&P by 1.8% percentage points over the past ten years and by 3.7% over the past twenty. Research by scholars Steve Kaplan and Antoinette Schoar suggests that for the earlier 21-year period from 1980 to 2001, average returns barely

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exceeded and may even have fallen below those for the S&P 500.

This is nothing to get excited about given the extra risk involved in PE investments, especially highly leveraged ones. To compensate, average annual PE returns should be an extra 1 to 3 percentage points higher than the public market, estimates Josh Lerner, a Harvard Business School professor who gave a presentation on PE returns at the Capital Matters conference. So over the longer term, the average PE buyout fund may add little to aggregate pension-fund performance. This is especially true given the five-to-ten-year lock-up periods most of them require.

Still, the amazing PE returns that make the front page aren't completely aberrational. The numbers in the accompanying chart are averages for 655 U.S. PE buyout funds. However,

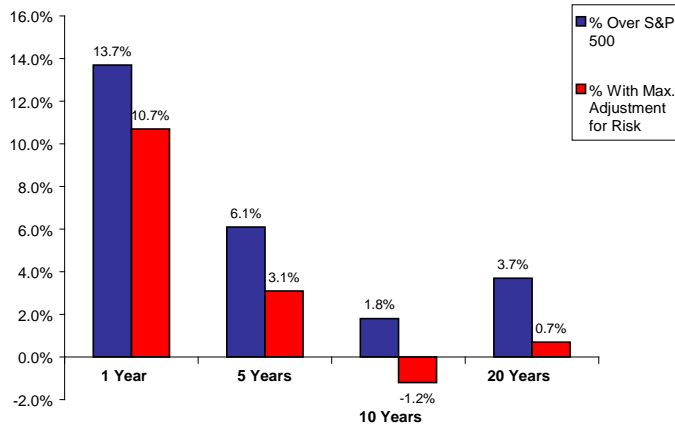
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The Pensions and Capital Stewardship Project focuses on issues of retirement security, including employment-based retirement plans, and pension fund governance and management. It is also concerned with institutions, systems, and practices of pension fund investment that encourage capital markets and corporate policies to work more effectively for workers and the health and well-being of the community at large. The Project does this through research, education, and engagement with scholars and researchers, workers and unions, and practitioners.

**Are private equity investments really so amazing?:
Private Equity Performance over S&P 500**



Source: "Buyouts Performance Review, Fourth Quarter 2006," Thompson Financial

some funds consistently outperform the pack – and hence the market, according to Kaplan and Schoar’s analysis. Indeed, there’s a 48% chance that a PE firm whose fund ranked in the top third of PE performance will come in there again with its next fund, they found.

But that still means a pension fund or other investor has roughly a 50/50 chance – a flip of the coin – of actually identifying one of those top performers. What’s more, Lerner and other experts say that it takes considerable expertise and staff resources to spot a fund in this top-third group in the first place. Among the reasons: PE firms typically raise money for a new fund before the books close on their old one. Since they’re trying to woo investors, they may be less than candid about any subpar performance in the old fund until it has completed its life cycle. So it can be a daunting task just to figure out who’s in the top-tier in the first place – before you flip the coin and hope you hit one that beats the market.

The bottom line: PE may be a smart way to find higher returns, but it’s by no means the sure bet it may appear to be.

To learn more, read:

"Smart Institutions, Foolish Choices: The Limited Partner Performance Puzzle," by Josh Lerner, Antoinette Schoar, and Wan Wongsunwai, *The Journal of Finance*, Vol. 62 Issue 2, April 2007, pp. 731-764. (For an earlier – January, 2005 - version available on the Web, see <http://ssrn.com/abstract=657482>.)

"Private Equity Performance: Returns, Persistence, and Capital Flows," by Steven N. Kaplan and Antoinette Schoar, *The Journal of Finance*, Vol. 60 Issue 4, August 2005, pp. 1791-1823 (For an earlier – November 2003 – version available on the Web, see <http://ssrn.com/abstract=473341>.)

For additional readings related to this article or any others in this newsletter contact Larry Beeferman, Director of the Pensions and Capital Stewardship Project: lwb@law.harvard.edu

Private equity can be labor friendly

There has been a growing outcry recently about private equity (PE) firms, especially in Europe. A senior German politician branded them as "locusts" devouring his country’s businesses, while a prominent union group in Europe warned that labor’s "experiences with employment and working conditions linked to private equity are alarming."

United Steelworkers union President Leo Gerard offered a similar assessment at the fifth annual Capital Matters conference, where he castigated PE as "predatory capitalism that’s just this side of a Ponzi scheme."

Even so, as Gerard pointed out, the USW and other U.S. unions have a decades-long history of working with at least some PE firms. Labor on both continents can learn from the positive experiences some unions have had in this arena. Pension funds, too, may get some useful lessons about how they can encourage labor-friendlier outcomes at the targeted companies – without sacrificing competitive returns. This was the subject of a March meeting, convened by the Project among representatives of private equity firms, Taft-Hartley and public sector pension funds, and union leaders.

Labor’s good relations with PE fall into several camps. Perhaps the most familiar in the U.S. are the real-estate trusts set up or inspired by building trades

unions to spur construction jobs. These trusts have been investing in residential and commercial construction projects since the 1960s. For example, the AFL-CIO Housing and Building Investment Trusts, the Multi-Employer Property Trust, and ULLICO’s J for Jobs, together currently have about \$15 billion in assets. While they are usually financed by labor pension funds, public sector funds have also invested in them. Moreover, several of the latter have established responsible contractor policies that apply to their real estate investments. (The SEIU’s Local 1199 pension fund has proposed similar policies for its private equity investments.)

Frequently, the firms work with labor to put the company back on its feet while preserving as many jobs as possible and minimizing wage and benefit cuts.

There’s billions more in other labor-friendly PE and venture-capital firms that specialize in transactions involving companies that are unionized or could go union. These types of investments grew out of the waves of

bankruptcies that engulfed industries such as steel, textiles, and airlines in the 1980s and 1990s. Frequently, the firms work with labor to put the company back on its feet while preserving as many jobs as possible and minimizing wage and benefit cuts.

A number of these PE firms have been operating successfully for years. The March conference heard about one investment made by KPS Capital Partners, LP, a nearly \$2 billion firm that has focused on buying troubled unionized companies and partnering with labor to fix the problems. That firm reports having earned excellent returns while saving some 11,000 jobs at the dozens of distressed companies in which it has invested over the years.

Such success depends on the PE firm's willingness to establish a close working relationship with unions at the affected companies. This, in turn, requires transparency about the company's business plan, its finances, and the transaction. It's particularly important in a turnaround for the PE firm to be clear about the kinds of changes that may be required to achieve it.

Another case study, more relevant to new or growth companies, suggested that a union's knowledge of an industry can help identify investment opportunities in markets for innovative products or services. It also pointed to how collaboration with unions on worker training and other issues can enhance the chances for those investments to be financially rewarding while at the same time offering prospects for new union jobs with good wages and benefits.

In light of the foregoing, meeting participants stressed how important it is for pension fund trustees, when deciding whether to include private equity investments in the fund portfolio, to ask for information about and consider investments that can achieve competitive returns while producing labor-friendly outcomes.

American and European labor have been calling for increased government regulation of the \$500 billion-plus PE industry. They want governments to reduce the tax advantages PE reaps from its extensive use of debt and to open the firms' books to the same oversight required of other major pools of capital. While those battles play out, there also could be opportunities for unions and pension funds to join hands with at least some PE firms.

To learn more, read:

"Building on Success: Labor-Friendly Investment Vehicles and the Power of Private Equity," by Michael Calabrese in *Working Capital: The Power of Labor's Pensions*, Ed. By Archon Fung, Tessa Hebb, and Joel Rogers, ILR Press, 2000. (For an earlier version, see [http://www.community-wealth.com/_pdfs/articles-publications/state-local/paper-](http://www.community-wealth.com/_pdfs/articles-publications/state-local/paper-calabrese.pdf)

[calabrese.pdf](http://www.community-wealth.com/_pdfs/articles-publications/state-local/paper-calabrese.pdf).)

"Inside the dark box: shedding light on private equity," by Phil Thornton, The Work Foundation, March 2007. Available at http://www.theworkfoundation.com/Assets/PDFs/private_equity.pdf.

"Methodological issues in estimating the impact of private equity buyouts on employment," by David Hall, PSIRU, Business School, University of Greenwich, May 2007. Available at <http://www.psiru.org/reports/2007-05-PE-emp.doc>.

Pension funds need better governance

Many pension funds devote plenty of attention to the corporate governance of the companies in which they invest, but focus much less on how they themselves are run. There are several keys to effective fund governance, according to University of Toronto finance professor Keith Ambachtsheer, who spoke at the Project's recent Capital Matters conference. Among them are Board self-evaluation; a strong internal executive; clear lines of responsibility between the board and management; appropriate human resource policies, including incentive compensation for management; and a trustee selection process that balances the need for individuals who are representatives of the employees the fund serves with those who can bring the skill and experience needed to manage billions of dollars. Ambachtsheer contended that better-governed funds enjoy returns that are 1 to 2 percentage points a year higher than those with poor governance. (His research also points to a difference in returns of 1 percentage or more between large and small funds, a

Recent and Future Events

- February 23, 2007: Meeting on "The Practice and Prospects for Collaboration Among Shareholder Activists"
- March 2, 2007: Meeting on "Private Equity Investments for Market-Based Returns and Labor Friendly Outcomes"
- May 2-4, 2007: Fifth Annual "Capital Matters: Managing Labor's Capital" conference
- July 26-27, 2007: First Program for Advance Trustees Studies sessions
- December 10-11, 2007: Seminar on "The New Finance of America's Cities" (in connection with the Public Sector Pension Funds and Urban Revitalization Initiative)
- April 16-18, 2008: Fifth Annual "Capital Matters: Managing Labor's Capital" conference
- June 9, 2008: National conference on findings and implications of Public Sector Pension Funds and Urban Revitalization Initiative



finding which points to merging funds that are too small.)

Oxford Professor Gordon Clark suggested that best-practice governance includes an optimal board size of 6-8 members, a governance sub-committee that regularly reviews board performance, and a focus on long-term innovation into which short-term decision-making should be integrated.

Samuel Halpern, President of Independent Fiduciary Services, emphasized the value of “operational reviews” – in effect, the equivalent of a regular, comprehensive “physical” for pension funds – as a means for assessing a fund’s operations, organization, and investment portfolio in light of best practices. Such reviews, when linked to a specific set of recommendations for concrete and feasible action, are an important means for identifying and avoiding undue risk, expense, and inefficiency, and achieving the desired net, long-term rate of return.

To learn more, read

“From Theory to Practice: Actually Governing Your Investment Program,” by Samuel Halpern, President, Independent Fiduciary Services, Fifth Annual Capital Matters: Managing Labor’s Capital conference, May 2007. Available at http://www.law.harvard.edu/programs/lwp/Session1_Halpern.pdf.

“Pension Fund Governance,” by Professor Gordon Clark, Oxford University, Fifth Annual Capital Matters: Managing Labor’s Capital conference, May 2007. Available at http://www.law.harvard.edu/programs/lwp/Session1_ClarkGovernance.pdf.

“The State of Global Pension Fund Governance Today: Board Competency Still a Problem,” by Keith Ambachtsheer, Ronald Capelle, and Hubert Lum, International Centre for Pension Management, University of Toronto, June 2007. Available at http://www.rotman.utoronto.ca/userfiles/departments/icpm/File/October%202006/Governance%20Study%20Paper_Submission_June%202007.pdf.

Some directors were backdating options, too

Pension fund trustees, in fulfilling their fiduciary duty to monitor investments, have paid increasing attention to the negative impact large executive stock option grants can have on corporate performance, including profits and returns on investment. The most recent controversy revolves around the outsized gains some executives have reaped through back-dating of their options. The general assumption has been that corporate boards, which are supposed to oversee option grants, fell down on the job. Either directors were asleep at the switch and missed the back-dating, or they knew about the cheating and did nothing to stop it. But there’s clear evidence that a significant minority of directors got backdated options, too, according to a study of options granted to 32,000 independent directors at 6,500 U.S. companies between 1996 and 2005. The study by Harvard law professor Lucian Bebchuk and two colleagues looked at all options granted to outside directors on days when the underlying stock hit its lowest price of the month. They then calculated how frequently this would have happened due to random chance.



Professor Lucian Bebchuk

The conclusion: A lot more options got granted than pure luck would allow, which is almost certainly explained by backdating. While the study can’t pinpoint which independent directors backdated, it concludes that about 1,400 did so at 460 companies. Bebchuk and his colleagues take this as evidence of a widespread breakdown in corporate governance. They also argue that director backdating undercuts the popular notion that companies need more outside board members with greater powers on the theory that they provide crucial objective oversight of management. In remarks at the Project’s recent Capital Matters conference discussing these findings, Professor Bebchuk urged investors to push for new corporate bylaws that would require shareholder approval of director compensation under certain circumstances.

To learn more, read:

“Lucky Directors,” by Lucian Arye Bebchuk, Yaniv Grinstein, and Urs C. Peyer, Harvard Law and Economics Discussion Paper No. 573, December 2006. Available at <http://ssrn.com/abstract=952239>.

“Inside Luck and Governance Reform,” by Lucian Bebchuk, Fifth Annual Capital Matters: Managing Labor’s Capital Conference, May 2007. Available at: http://www.law.harvard.edu/programs/lwp/SessionIV_Bebchuk.pdf.

Research Spotlight

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"Alan is still recovering from the near-death experience of his mutual fund."

Are pension funds better asset managers than mutual funds?

The answer is yes, at least according to a recent study by Bauer and others of the domestic equity portfolios of 716 U.S. defined benefit (DB) plans for the period 1992-2004 and 238 defined contribution (DC) plans for the period 1997-2004. The authors measured the net performance of these corporate, public, and other pension funds compared with that of a size-matched sample of mutual funds. Net performance is the gross fund return less the fund-specific benchmark return and costs (which in the case of DB plans, includes direct investment, oversight, custodial and trustee, audit and other related costs and in the case of DC plans, record-keeping, communication and education costs).

They report that pension funds outperform mutual funds by approximately 2.5% per year. Even after adjusting for account fund size, the difference is still about 1.5%. When they take into account risk and style they find that the differential between pension fund and mutual fund

...pension funds outperform mutual funds by approximately 2.5% per year

performance actually grows to more than 2.0%.

Why is there such a difference? According to the authors, it is not because of skill factors, costs, fund type, the degree of outsourcing, the number of DC investment options, or DC company stock holdings. Rather, the authors propose that the real source of the difference could be the result of "agency costs." That is, pension funds are better than mutual funds at assuring that their interests and those to whom they delegate portfolios to manage are aligned. For example, they suggest that pension funds, whose assets are often managed in external accounts, have the capacity to monitor those accounts

more rigorously for hidden costs. Also, they propose that the efficient pooling of money in large pension plans enables them to exert negotiating power with asset management providers, which lowers the general cost level.

What might these reported differences mean for the average working person? According to estimates by Amachtsheer and Bauer which yielded similar results for Canadian pension and mutual funds, for a worker earning a constant \$50,000 over a 40-year working lifetime and saved \$10,000 per year, a difference of a 1.5% in net performance could result in a loss of over \$150,000 in lifetime savings (or a 26% percent point drop in the working income replacement rate) at retirement.

To learn more, read:

"The Performance of US Pension Funds, New Insights into the Agency Costs Debate," by Rob Bauer, Rik Frehen, Hubert Lum and Roger Otten, February 26, 2007. Available at http://www.uc3m.es/uc3m/dpto/EMP/seminar/documents/otten_000.pdf.

"Losing Ground, Do Canadian mutual funds produce fair value for their customers?" by Keith Ambachtsheer and Rob Bauer, *Canadian Investment Review*, Spring, 2007. Available at http://www.investment-review.com/archives/2007/spring/CIR_01-2007losingground.pdf.

Trustee Education

First Program for Advanced Trustee Studies

On July 26-27, 2007, the Project, in partnership with the National Conference of Public Employee Retirement Systems, held its first Program for Advanced Trustees Studies (PATS) for experienced pension fund trustees. Approximately fifty trustees from a wide range of public sector pension funds participated in the sessions, which focused on two topics. One was concerned with the legal, policy, and other arguments for and against pension fund investing for economic and community development and, if the choice is affirmative, best practice in making such investments. The other focused on lessons to be learned from a scandal in San Diego involving pension fund trustees and pension and city officials which has, among other things, resulted in state and federal criminal indictments against some of the foregoing. Participants actively engaged in discussions of the issues posed. When surveyed, they expressed very positive views about their experience at sessions. Plans are in process for a second PATS program on July 22-24, 2008.

If you are interested in applying, please contact Larry Beeferman, Project Director: lwb@law.harvard.edu

A new solution for America's retirement woes?

America's inadequate retirement system has been an issue of mounting concern in recent years. Even if Social Security's predicted shortfall eventually gets plugged, it still only provides roughly 40% of the average 67-year-old's pre-retirement income – a long way from the 70% or so many experts say is needed. Retirement plans and other savings are supposed to make up the difference. But many families spend nearly everything they make. And despite all the attention 401(k)s get as a retirement solution, 40% of the U.S. workforce lacked any type of employment-based retirement plan, whether it was a defined-contribution (DC) account like a 401(k), or a traditional defined-benefit (DB) pension, according to a 2003 government survey.

At this point, it's clear that the U.S. needs a new idea. One possible fix would be to boost Social Security income by hiking the payroll tax workers and employers now pay. Another would be to replace the 401(k), which has failed to help a majority of workers. Several experts recently have suggested a hybrid public-private substitute for the 401(k) that marries its individual account attributes with elements of a Social Security-type government plan.

One thought-provoking hybrid was put forth by University of Notre Dame economist Teresa Ghilarducci at the Capital Matters conference in early May. She designed the idea, called a Guaranteed Retirement Account (GRA), based on what she terms the "Principles of a Good Retirement System." (See Box.) The plan would ensure universal participation, remedying a key failing of 401(k)s. Like Social Security, GRAs would rely on a mandatory payroll tax – in this case, 5% – half paid by the employee and half by his or her employer. The tax would be paid on earned income up to the Social Security earnings cap, currently \$97,500, although workers could put in more with post-tax dollars. Coupled with Social Security, GRAs would lift the average worker up to the 70% replacement level.

Uncle Sam would guarantee GRA holders a minimum return tied to economic growth. This would deal with yet another 401(k) failing, namely, the exposure of individuals to market swings. Ghilarducci says that the risk to Washington's pocket book would be minimal, since GRA funds would be invested in stocks and bonds, whose long-term returns should at least keep pace with the economy's growth rate. Workers would get their payout as an annuity, ending the problems that occur when Americans dip into their 401(k)s before they retire or mismanage lump-sum payments at retirement.

Principles of a Good Retirement System

Pensions should be efficient, fair, and based on mutual responsibility and shared risk. To achieve this they should:

- 1 Prevent a sharp drop in living standards after retirement.
- 2 Reduce poverty and not exacerbate income and wealth inequality.
- 3 Reward effort.
- 4 Not require people to work longer.
- 5 Not make individuals bear all the employment, longevity, financial, default, and inflation risks.
- 6 Ensure that benefits are predictable and portable.
- 7 Ensure that employer costs are predictable.
- 8 Not allow access to retirement savings for healthcare, job changes, home buying, education, and other expenses unrelated to retirement or disability.
- 9 Be cost effective, transparent, and accountable; take advantage of economies of scale; and not waste money on marketing, retail fees and other unnecessary costs.
- 10 Not distort economic activity or destabilize the economy.

GRAs also would remedy the regressive tax break for 401(k)s and other DC plans, 71% of which go to the top fifth of taxpayers. Under Ghilarducci's proposal, Congress would re-direct the \$125 billion a year now spent on tax breaks for both DB and DC plans to pay for a \$600-per-employee refundable tax credit that would be split equally by workers and employers. (DB plans funded at 5% of payroll per year could keep the current tax break, preserving most union and other well-funded pension plans.) The \$600 would cover the GRA's full cost for a minimum-wage worker and much of the tab for other lower-income employees.

Ghilarducci proposes that GRA funds be managed as one big pool by an independent board, similar to the one that now runs the Thrift Savings Plan, the federal employees retirement plan. Managed in this way, her plan achieves economies of scale and eliminates the pricey fees and other costs that make 401(k)s an inefficient savings device.

GRAs or something like them would bring plenty of negatives for higher-income families that now reap most of the benefits of the 401(k). They would get a much

smaller tax break, couldn't earn high rates of return through smart investments, and couldn't leave GRA money for their heirs. But something like the GRA would be a boon to the many Americans whose golden years currently look bleak. The principles on which it is based offer an important starting point for research, analysis, and public debate.

To learn more, read:

"Guaranteed Retirement Accounts: Towards Retirement Income Security," by Teresa Ghilarducci, April, 2007. Available at <http://www.law.harvard.edu/programs/lwp/GhilarducciGRAApril2007NET.pdf>.

"Retirement Plan Coverage of Boomers: Analysis of 2003 SIPP Data," by Satyendra K. Verma, AARP Public Policy Institute, August 2006. Available at http://assets.aarp.org/rgcenter/econ/sipp_cb_2006.pdf.

"Retirement at Risk: A New National Retirement Risk Index," by Alicia H. Munnell, Anthony Webb, and Luke Delorme, Center for Retirement Research at Boston College, Issue in Brief #48, June 2006. Available at http://www.bc.edu/centers/crr/special_pubs/NRRI.pdf.

"Retirement savings and household wealth: Trends from 2001 to 2004," by Patrick Purcell, Congressional Research Service, May 22, 2006. Available at <http://digitalcommons.ilr.cornell.edu/crs/21/>.

"Retirement Annuity and Employment-Based Pension Income Among Individuals Age 50 and Over: 2005," by Craig Copeland, Employee Benefit Research Institute, Vol. 28, No. 3, March 2007, pp. 2-7. Available at: http://www.ebri.org/pdf/notespdf/EBRI_Notes_03-20071.pdf.

Investment for competitive returns and local economic impacts

Can U.S. pension funds help breathe new life into the country's decayed inner cities and other communities? Yes, according to the Public Sector Pension Funds and Urban Revitalization Initiative, a three-year-old undertaking by Oxford University researchers affiliated with the Project. According to the researchers, U.S. pension funds have invested more than \$7.1 billion into such projects, which have the dual goal of earning risk-adjusted market returns and of revitalizing poverty-stricken downtowns or spurring economic development to build housing, create jobs, and the like.

Their case studies of investments of this kind by the California Public Employees Retirement Systems (CalPERS), the California State Teachers Retirement System, the New York City Employees Retirement System, and the Massachusetts Pension Reserve Investment Management Board suggest that pension funds can be successful, but only if they establish a selection process as rigorous as that used for traditional investments and track and monitor progress against contractual benchmarks.



"South Boston Street" by Dale Ratcliff

The biggest player is CalPERS, which has posted 20% annual returns since 1997 in its \$4.2 billion California Urban Real Estate program, which focuses on inner-city real estate investments. CalPERS reports positive results from its California Initiative Program (CIP), which targets companies that have limited access to capital, that employ workers who reside in economically disadvantaged areas, and that have female and/or minority management. Research is in progress to assess CIP's returns and outcomes.

The Project's Initiative has convened meetings of public sector pension and government officials, investment firms, community development finance and other organizations in Richmond, Virginia, Hartford, Connecticut, and Boston, Massachusetts to discuss its findings and recommendations for best practices, and how to increase these investments. It another meeting, to be convened in Cleveland, Ohio, is tentatively set for December 5th.

For reports on Initiative research and meetings, see <http://urban.ouce.ox.ac.uk/research.php> and <http://urban.ouce.ox.ac.uk/events/>, respectively.

See also: "The Economic Impacts of CalPERS Investments on the California Economy," Prepared by Applied Research Center, California State University for CalPERS, September 2007, available at <http://www.calpers.ca.gov/eip-docs/about/press/news/economic-engine/eco-study-calpers-inv.pdf>, and "Impacting California's Underserved Communities: Taking a Second Look," Prepared by Pacific Community Ventures for CalPERS, 2007, available at <http://www.pacificcommunityventures.org/media/pdf/2006-CalPERS.pdf>.

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