THRIFT SAVINGS PLAN

FEDERAL RETIREMENT THRIFT INVESTMENT BOARD
77 K Street, NE Washington, DC 20002

GREGORY T. LONG
Executive Director

March 15, 2012

Memorandum for Board Members Kennedy, Duffy, Bilyeu, Jones
and McCray

From: Greg Long, Executive Director
Tracey Ray, Chief Investment Officer

Re: Hewitt EnnisKnupp Index Fund Recommendation

The TSP requested that Hewitt EnnisKnupp (HEK) review and evaluate the appropriate indices to use for the following investment options:

- Common Stock Index Investment Fund (C Fund)
- Small Capitalization Stock Index Investment Fund (C Fund)
- Fixed Income Investment Fund (F Fund)
- International Stock Index Fund (I Fund)

After an extensive review, HEK opined that the indices used for the C, S, and F Funds remain the most appropriate. However, their report includes a recommendation to change the I Fund benchmark from the MSCI EAFE Index (EAFE) to the MSCI World ex U.S. Index (World ex U.S.), which is EAFE plus the Canadian stock market.

The primary reason for the recommendation is that the Canadian stock market has now become the third largest after the United Kingdom and Japan and comprises 11.4% of the MSCI World ex U.S. Index.

This memo will explain why we believe that the change will not result in material benefit to participants and therefore does not justify the implementation cost.

The Index Is Not a Widely Used Benchmark

According to statute, "the Board shall select an index which is a commonly recognized index comprised of stock the aggregate market value of which is a reasonably complete representation of the international equity markets excluding the United States equity markets."

We concur with HEK's justification for using the MSCI family of indices.

However, as shown in the following table, with $144 billion of benchmarked assets, the MSCI EAFE index is the most widely used index. Despite the fact that the EAFE and World ex U.S. Indices were established at the same time, in 1969, only $36 billion of assets are benchmarked to the latter.

	Established	Assets ($ billion)
EAFE	1969	144
World ex U.S. -- EAFE + Canada	1969	36
ACWI ex U.S. -- EAFE + Canada + EM	1994	64
ACWI ex U.S. IMI -- EAFE+C+EM*	2007	76

*Investable Market Index (includes emerging and developed small capitalization stocks).

The first index to include emerging markets was launched 25 years later in 1994, and further expanded in 2007. Investors have embraced the international indices, which contain emerging markets, with a total of $140 billion invested thus far.

Investors have shown a preference to invest in either EAFE or the ACWI benchmarks which include emerging markets. (HEK determined in its evaluation that emerging markets remain too illiquid to handle the sometimes very large activity that occurs in the TSP plan.)

Although the TSP is moving to using separate accounts instead of commingled funds, further evidence of the lack of popularity of the World ex U.S. as a benchmark is that no daily valued index fund exists. Two out of the five largest EAFE index managers do not manage any assets benchmarked to the proposed index.

Risk Return Profiles Are Not Materially Different

The return and risk profiles of EAFE and World ex U.S. do not differ materially. According to HEK's report, the correlation coefficient of the two indices is 0.999. Given such a high correlation of the returns of the two indices, one would expect virtually identical performance.

Despite the broader diversification of the proposed index, the volatility has been greater than the current benchmark for the past 25 years. In the HEK report, volatility was measured in 5, 10, 15, 20, 25, 30, 35, and 40 year time periods. As measured, the volatility of World ex U.S. has been greater than EAFE for all of those periods from 25 years to the present.

Based on these quantitative measurements, there is no benefit in changing the index.

Transition Costs

The recommended index change could also result in costs to participants. By HEK's calculation, transition costs could be as high as $35 million. Additionally, the transition would bring complexity to the administration of the plan. The transaction would not be accomplished in a single day, necessitating operating two funds with two different benchmarks for a short period of time. The transition was not addressed in detail in the HEK report, and there is currently no recommendation as to how to execute it.

While this change would be fairly seamless in a defined benefit plan, the nature of a defined contribution plan requires advance notice to the participants, and a participant mailing would likely cost an additional $3 million. As previously explained to the Board, the Pension Plan Protection Act of 2006 amended ERISA to provide that the safe harbor applicable when a participant exercises control over the assets in his or her account is also applicable when a <u>qualified change in investment options</u>[1] occurs. The safe harbor provision requires notice to participants at least 30 and no more than 60 days before the change and must explain that, absent the participant's direction to the contrary, the participant's account will be reallocated to the new investment option. Although FERSA does not contain a similar provision, it would be prudent for the Board to follow ERISA's requirements because that is the standard used by most of the industry. Because of the cost and administrative issues that would arise as a result of an index change, the change should be meaningful.

In summary, we do not agree with HEK's recommendation to change the index for the I Fund to the MSCI World ex U.S.

- It is not a widely used benchmark;
- Returns are not meaningfully different and volatility is greater;
- Therefore, the costs and administrative complexities associated with the change are not justified.

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[1] A qualified change in investment options occurs when a participant's account is reallocated to a new investment option with characteristics, including risk and rate of return, that are similar to the characteristics of the current investment option. I believe a move of the I Fund benchmark from the MSCI EAFE Index (EAFE) to the MSCI World ex U.S. Index (World ex U.S.) would satisfy these requirements.