Statement of Barclays Global Investors

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Good afternoon, Mr. Chairman and members of the Committee. My name is Francis Enderle and I am the Chief Investment Officer for the Global Index and Markets Group at Barclays Global Investors (BGI). In that role I am responsible for, among other things, the oversight of portfolio management in the US of all of BGI's index strategies.

We are pleased to be here today to share with the Committee our expertise in the management of defined contribution pension accounts, which is derived from our experience as the external asset manager for the Federal Thrift Savings Plan ("TSP") as well as for numerous other public and private pension plans. We are honored to have served as an investment manager for the TSP since 1988, a relationship we have retained in regular, highly competitive bidding processes.

I will begin by discussing our investment philosophy and our structure, both of which are focused on delivering highly reliable, low cost investment results to institutional investors like the TSP. By 'institutional' I refer to defined benefit and defined contribution pension plans sponsored by corporations or public agencies, and to endowments, foundations and other similar pools of capital. I will then say a few words about the services we provide to the TSP, and elaborate on how we keep the costs associated with trading and investing as low as possible. I will conclude by turning to the investment related issues to be considered if the federal government were to legislate individual investment accounts either as part of Social Security reform, or through another mechanism.

Barclays Global Investors was founded in 1971 as part of Wells Fargo Bank in San Francisco, California. Today, we are owned by Barclays PLC, one of the world's leading financial service providers. We are headquartered in San Francisco with approximately 1,100 employees in California and elsewhere in the U.S. and 1,100 more employees worldwide serving the needs of our global clients. With more than $1.3 trillion in assets under management, BGI, together with its affiliates, is the world's largest index manager. BGI created the first index strategy in 1971, just one of many financial innovations we have pioneered.

Since our founding, BGI has remained true to a single global investment philosophy, which we call *Total Performance Management*. BGI manages *performance* through the core disciplines of *risk*, *return* and *cost* management. The success of our indexing methodology results from our focus on delivering superior investment returns over time while minimizing trading and other implementation costs and rigorously controlling investment and operational risks. This approach helps us avoid investment "fads" or a dependence on "star managers" or "stock pickers." It has been the foundation for the way we've managed money for over 30 years and we believe it has served our clients very well.

As I noted earlier, since 1988 one of those clients has been the TSP. BGI manages four of the five investment options available for participants—the TSP 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) and the I Fund (based on the MSCI Europe Australia Far East (EAFE) index of non-US equities). The fifth option, the G Fund, is managed by the US Treasury and invests in US Treasury securities. Later this year, the TSP will be launching a series of lifecycle or 'target horizon' options that use the existing five options as the asset class 'building blocks' with allocations in each lifecycle fund across these options being determined by an external vendor. I will describe shortly the structure of these new options, as well as the benefits they will provide to plan participants. .

BGI's services to the TSP are completely focused on investment management. We do not provide any other services. We have an extremely effective operating model developed in conjunction with TSP staff to manage the daily cash flows into or out of each of the investment options. Each day we receive an instruction for each fund that aggregates the transaction instructions of all TSP participants placing orders on that day. In this way, the orders for participants buying or selling from the same fund are netted against each other and only a trade for the residual order is placed.

Management of payroll contributions, record keeping (e.g., changes made by participants in investment elections), distributions and communications to participants are handled directly by the TSP or its other vendors. This is also true for most of our other clients—our core expertise is investment management, and our comments are provided principally from this perspective. Minimizing transaction costs in all our investment activities is a central element, Mr. Chairman, in how we do our business. In fact, the key to our success in index management has been our ability to minimize implementation and trading costs. High costs and expenses of investing detract from performance and investment returns; lower costs increase the investment pool and put more money long-term into the pockets of investors. Let me say a few words about how we do this.

Each of our index funds is structured to match the performance of a specific index. These indexes (such as the S&P 500 or the MSCI EAFE) are designed by third-party index providers. However, these indexes are really 'paper portfolios' and do not include any of the trading costs that real-world investors experience. Thus to successfully achieve the performance target—that is, to track the index as closely as possible—BGI strives to minimize the "real world" costs through a variety of highly efficient trading approaches.

Through the size and diversity of our client base we are able to match or offset a significant percentage of our clients' buy and sell orders internally, thereby reducing or eliminating market transaction costs. The internal matching of buy and sell orders is commonly referred to as "crossing," and is conducted and actively monitored by BGI pursuant to the terms and conditions of an exemption issued by the Department of Labor.

When we do trade in the markets, we utilize carefully developed and managed trading strategies and we access all possible sources of liquidity, including electronic marketplaces. Our trading activities are supported by a dedicated trading research team, whose sole job is to develop new trading techniques and strategies to minimize trading costs.. We execute our trades through broker-dealers who have been pre-screened for credit-worthiness, and we rigorously monitor the prices at which our trades are executed relative to a number of market-related benchmarks to ensure we are receiving superior execution. We also use our scale to negotiate low per share commission rates.

The majority of our assets are managed for large institutional clients such as the TSP and the average account size for our US clients is $880 million. BGI is able to charge lower investment management and administrative fees to its institutional clients than a mutual fund firm geared towards retail investors, where the average account size is comparatively small. And in dealing with institutional investors we do not have the costs of retail administrative services (including shareholder communications and recordkeeping), which also serve to raise the costs of retail fund managers. By way of example, the average fee for large-capitalization US equity index portfolios of $100 million in size that are managed for institutional clients is 0.05% versus retail-oriented equity index mutual funds where the fees average 0.69%[1], more than 10 times greater than our expense ratios.

Over the course of a long-term investment, lower management fees and expenses (including trading commissions) can translate into considerable savings for any investor. Indeed, index investing remains the most cost-efficient and diversified way to gain exposure to various segments of the capital markets. We believe index funds are the best core investment for most investors' portfolios – whether they are the largest pension fund in the world, or an individual investor.

I'd now like to make a few comments regarding investment management considerations if personal accounts are adopted as part of any future changes to the Social Security program.

Let me first acknowledge that BGI has built a substantial part of its business by offering well-managed index strategies to our clients for more than 30 years. We therefore have a vested interest in the continued growth of index investing. Our interests aside, we firmly believe that the reason for the success of these strategies is the simple fact that they deliver the return of the market index reliably and cost effectively. In fact, Congress recognized this itself in the enabling legislation for the TSP, which provides that the four public market options be invested in portfolios designed to replicate the performance of an index that is 'commonly recognized' as reflecting the performance of each asset class (i.e. the S&P 500 Index for large capitalization US equities).

[1] Source: Morningstar, BGI 2/05

If a national system of personal accounts were to be implemented, we would encourage legislators to consider the following approach that draws on the best practices of institutional investors.

An array of low cost, broadly diversified index funds frequently forms the core investment for institutional pension plans, both defined benefit and defined contribution structures. For example, the current selection offered to TSP participants covers all the main asset classes—large and small capitalization US equities, US fixed income, international equities and a stable value option. Other asset classes could be included but these options would provide the basic 'building blocks' and coincide with what one would typically see in a well-constructed institutional portfolio.

We suggest consideration of index portfolios because they offer three principle benefits to investors:

- They capture the return of each asset class (as represented by a benchmark index such as the S&P 500) with a high degree of precision;
- Index funds typically have low asset management fees as compared to actively managed funds;
- Index funds have lower relative transaction costs including commissions, bid/ask spreads and market impact. This is because index fund investments are spread across a large number of securities thereby reducing the impact of a portfolio

trade on an individual security relative to what would occur in a more concentrated portfolio.

The latter point is worth elaborating upon given the sizeable assets that would potentially be invested in personal accounts. Investing in index funds spreads assets across the broadest possible array of securities in any asset class thereby minimizing the impact of trading large cash flows in the market on a daily basis. This is not only important for the investment of new monies into personal accounts but also for any trading that individuals may initiate in their personal accounts to reallocate assets among their investment options over time.

Another investment option to be considered is an array of so-called lifecycle or 'target horizon' funds, options that the TSP will be adding later this year, as I mentioned earlier. With lifecycle funds, potentially the only choice an investor needs to make is to select the lifecycle fund with the target horizon date that most closely matches the investor's date of retirement. Each lifecycle fund would hold an array of asset classes with each asset class being implemented with an index fund. The asset mix within each lifecycle fund would gradually become more conservative over time as the target horizon date approached. For example, a participant who is 30 years of age today and a set retirement of, for example, age 65 would be invested in a lifecycle fund with a target horizon date of 2040.

As with the index fund options described earlier, a lifecycle fund option could also be structured as a very low cost solution to investors. While a lifecycle fund would not necessarily need to be invested in index funds, index funds likely provide the lowest cost solution for each asset class, and assure that the return of each selected asset class is reliably captured. Participants in each lifecycle fund would benefit from the fund's gradual evolution to a more conservative investment risk profile as the participant approached retirement.

Mr. Chairman, we believe that the investment considerations we have discussed will assist you and others on this Committee in evaluating the criteria to be used if personal accounts were to be legislated by Congress as part of revisions to the Social Security program, or in another program. I thank you for the opportunity to speak with you today and I look forward to answering any questions you may have.