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Five Investing Lessons from America's Top Pension Fund.

The sages at TIAA-CREF manage $210 billion for America's teachers and earn high returns the old-fashioned way: with long horizons and low expenses.

"Listen to the teachers." I don't know about you, but I used to hear that all the time from my parents -- and it was good advice for a young student. It's good advice for an investor too: A little-known outfit nicknamed "The Teachers" is indisputably the biggest and, I think, the best pension fund in the country. In an exclusive look inside this historically secretive organization, I recently spent a couple of months exploring how the Teachers Insurance and Annuity Association-College Retirement Equities Fund manages more than $210 billion in retirement annuities for America's educators. I found that TIAA-CREF offers one compelling investment lesson after another.

Its customers are limited, at least for now, to employees and their spouses at more than 6,300 private schools, colleges, teaching hospitals and other nonprofit institutions. (By way of disclosure: My wife, a private school teacher, is one of TIAA-CREF's 2 million investors.)

The Teachers is a throwback to the days when a money-management firm was expected to focus more on serving its existing customers than on the profits to be had by attracting new ones. In fact, TIAA-CREF was founded in 1918 by Andrew Carnegie for the exclusive benefit of educators and researchers, and it remains a nonprofit organization. It can, and does, resist the fads of the moment, and instead has built its success in a quiet and unflashy manner in line with five main principles that any investor can, and should, emulate.

Lesson 1: Keep it simple.
Despite The Teachers' immense size, the firm offers only 10 basic investment choices, including a stock index fund, growth stocks, bonds, global equities and a money-market fund. By contrast, Putnam Investments manages $151 billion in mutual funds -- but spreads that across a bewildering buffet of 78 portfolios. These include the remains of several risky option income funds that were all the rage in the 1980s. Other big fund families dabbled in short-term global bond funds when they came into fashion around 1991 or launched a slew of foreign-stock funds so narrowly focused that the collapse of a single market can cut their value by 10% in one day's trading.

Unlike most large fund companies, TIAA-CREF has never promoted, or even offered, such tightrope-walking investments. "We don't have any dangerous products," declares TIAA-CREF chairman John Biggs.

Americans tend to think that more choice is always better, but in fund investing that's not necessarily so. In a provocative article in the July/August 1997 issue of the Financial Analysts Journal, Richard Ennis, an institutional investment consultant in Chicago, observed that in nature some species spawn such huge numbers of offspring that the parents can devote only limited attention to each. Others bear very few young but dote on each one. In the first group, think of the ocean sunfish (which grunts out 300 million eggs at a time) and prolific fund companies like Putnam and Fidelity. In the second group, think of Homo sapiens, with only a few pampered children per family, TIAA-CREF.

Biggs explains that "with only 10 options, we can't afford to have a bad one." Thus the $5.5 billion CREF Global Equities Account, bolstered by the research of eight country analysts, returned 17.7% averaged annually over the past five years vs. 14.2% for the typical global fund. Likewise, the $4.4 billion CREF Growth Account, which invests in U.S. companies with rapidly expanding profits, shot up 29.3% through Dec. 1, beating the 18.08% return of the average growth fund, thanks to the research skills of The Teachers' 16 industry analysts.

What's more, by resisting the temptation to offer 200 funds, TIAA-CREF encourages its investors to focus not on which funds to own but on which asset classes to own -- U.S. and foreign stocks, bonds, cash or real estate -- depending on each individual's risk tolerance.

Lesson 2: Play to your strengths.
Instead of trying to manage every kind of fund imaginable, TIAA-CREF sticks to what it does best. Its flagship CREF Stock fund currently indexes 72% of its assets, passively replicating the portfolio of the Russell 3000 index of large, mid-size and small stocks. Another 15% of that fund's assets go into foreign stocks, where The Teachers' research team can eke out an edge. The rest goes into a relative handful of stocks about which senior managing director Douglas Dial and his analysts have what he calls "a high degree of conviction."

Similarly, its managers have turned the $88 billion TIAA Traditional Annuity Fixed-Income account into a teeming grab bag of value investments in directly owned real estate, commercial mortgages, private loans to businesses and even foreign debt. Its size gives TIAA first dibs on many high-quality private debt offerings. And thanks to the credit research of more than 240 in-house analysts, the account not only has a triple-A rating but has also pumped out a market-beating 8.04% average annual return over the past decade.

On another front, the $690 million TIAA Real Estate Account draws also on the expertise of TIAA's own staff of seven engineering and environmental experts to inspect properties before they go into the portfolio. Thus, unlike other realty funds, the TIAA account can own real estate directly rather than secondhand through real estate investment trusts (REITs).

If you aren't eligible to invest with TIAA-CREF, playing to your strengths means considering why the sages who run the pension fund have indexed most of their stock assets. There's a good reason: In the long run, the markets, especially for large-cap and midcap stocks, are pretty darned efficient. An index fund that replicates the S&P 500 or the Wilshire 5000 is likely to beat roughly three-fourths of all actively managed funds over the long term -- in large part because index funds keep turnover and expenses very low. Which brings us to our next two lessons.

Lesson 3: Buy and hold.
Trading in and out of stocks costs big bucks, especially at megafunds that can drive up their own purchase price and depress their own selling price. At some hyperkinetic funds, transaction costs can reduce returns by as much as two percentage points a year. Yet the public's focus on short-term performance spurs the average fund to turn over its typical stock every 14 months.

TIAA-CREF, however, holds its average stock for five years. One reason: Because it is a pension fund, its customers generally cannot touch the money until they retire. A typical participant may pay into his account over the course of 30 years, which enables The Teachers' fund managers to be patient. But that's also their temperament. Dial compares "true investing" with farming: "You have to plant and cultivate and fertilize -- and not expect instant results." Adds Martin Leibowitz, TIAA-CREF's chief investment officer: "When you're a long-term investor, you don't have to know exactly when the market will finally realize that its perception of a company was wrong. You only have to know that it will."

Lesson 4: Keep expenses low.
TIAA-CREF pinches its pennies until they squeal. CREF Stock, with total operating expenses of just 0.31%, is more than four times cheaper than the average U.S. stock fund; the Global Equities Account, at 0.38% in expenses, is more than five times cheaper than the typical global fund; and the TIAA Real Estate Account costs just 0.6%, roughly a third the cost of the average realty fund -- even though it is more actively managed.

How do they do it? Though TIAA-CREF has taken baby steps toward exanding its clientele (for example, to include participants' spouses, as well as teachers in some public elementary schools), it has, at least for now, little interest in attracting customers beyond its traditional base of educators. It therefore holds to a minimum the marketing costs that most other funds pass along to their investors.

If your fund manager is a genius, he might be able to outperform the average fund by one or two percentage points a year. TIAA-CREF locks in nearly that large an advantage merely by charging such low fees. "Over time and market cycles," says Leibowitz, "there's only one thing for sure in the investment world, and it's not performance. It's expenses. Keeping them as low as possible is the one sure thing you can do for your customers" -- or, if you're an individual investor, for your portfolio.

Lesson 5: Expect loyalty -- and give it.
TIAA-CREF reaches out to its customers in a way that puts most of the fund industry to shame. Chairman Biggs estimates that The Teachers will spend more than $200 million this year on customer service. It operates 11 regional offices and employs more than 600 licensed professionals -- paid by salary only, not by commission, so there's no sales pressure -- to give its customers advice on their investments. Last year alone, reckons vice president Madeleine d'Ambrosio, as many as 85,000 TIAA-CREF customers attended seminars to learn more about retirement planning. And in 1998, The Teachers' new trust company will begin giving financial planning advice that will cover investments offered by other firms. All of this encourages even the jumpiest investor to stick around for the long haul.

Fund managers at other investment firms frequently complain to me that their customers are too impatient, selling their funds at the first whiff of underperformance. That makes it tough for the portfolio managers to invest in stocks that might go down a little more in the short run before they go up a whole lot in the long run -- and that sort of lost opportunity isn't good for them or for you. If there's one lesson you should learn from The Teachers, it's the power of patience.

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