

Quarter Ended 3/31/09 Performance Meetings

May 28, 2009

Retirement Fund Conference Room

Board of Trustees Present:

Joe T. San Agustin, Chairman, Board of Trustees
Wilfred P. Leon Guerrero, Ed.D, Chairman, Investment Committee
Gerard A. Cruz, Member -?
Antolina S. Leon Guerrero, Member

Staff Present:

Paula M. Blas, Director
Diana Bernardo, Controller
Rosalia Bordallo, General Accounting Supervisor

Other Present:

Terry Dennison, Mercer Investment Consulting

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Defined Contribution Plan: Page 15

Defined Benefit Plan

10:00am-11:00am DB Plan - Quarterly Performance

We're clearly in some kind of transition, it's not obvious what we're transitioning to, but things are different in the economy from where they were toward the end of last year. Clearly there's been an enormous contraction of economic activity around the world, not just the U.S., although it probably started in the U.S., but basically everywhere in the world, but it's operating at a different time scale, the U.S. has been in recession officially, since December of 2007. Europe is probably getting to the point where we were a year ago and their economic slowdown can be a little bit more extreme than ours. Interestingly, the emerging markets which historically the old joke was if the developed markets get a cold, the emerging markets get pneumonia. The reality is the emerging markets are going better than the developed markets, economically, and the securities markets. They've now grown to the point where they have an indigenous middle class that supports consumption, they've got a much more diversified economy, instead of simply being an economy that's based on low end or low valued manufacturing or extraction of basic materials. I think it'd be fair to say that this is the first synchronized global recession since 1970.

The thing that's troubling to economists and others is historically the engine of recovery that has pulled the world out of recession or the U.S. out of recession has been the U.S. consumer. U.S. consumer's propensity to spend whether or not they have the money has been what's pulled us out of recession in the past. Prior to 2007, the U.S. consumers spending constituted about 65-70% of GDP, so basically the economy was largely driven by consumer spending. The consumer spending was largely driven, not by earnings, but by borrowing, they borrowed on their house, they borrowed on their credit cards, they borrowed on anything they could get their hands on and the reality is we're not in a process that's

known as de-leveraging, we are taking debt out of the system and this is going to be very painful. The consumer is still very broke, they feel threatened with their job, hours worked have fallen into the mid 30s on a weekly basis because so many people are on short hours or on part time and the reality is now people are very uncomfortable spending any money. The savings rate which the U.S. had gotten to is zero or below zero depending on how you want to account it, is now up to about 6% and the reality is the consumer is simply not available to pull us out of the recession and at this point the only serious engine to pull us out of the recession is probably going to be Government spending. Antolina Leon Guerrero: Isn't that what they call the paradox of thrift? Terry Dennison: Yes, we are going to talk about the paradox of thrift, while all the talk was that saving money is good, unfortunately the Government prefers that you didn't hock up to your ears again.

There does seem to be some improvement and this is sometimes called by economists, the green shoots of recovery, you have to look to find it and it's certainly mixed, it's not clearly a case of things are obviously getting better and you can tell by the behavior of the stock market. One thing that's different this time is the staggering amount of Government efforts in terms of stimulating the economy, providing liquidity, and we'll get into some of the scale of the numbers which are truly breath taking and of course these numbers involve all borrowed money, there is no money that's actually available for this, there's no rainy day fund, there's no reserves, all of this is spending money that we as an economy, a society don't have.

The situation in Europe, their banks had difficulty also, we had several banks in the UK fail and basically are nationalized and there have been tremendous injections into a number of major European banks. The issue in Europe is they don't have as well structured response mechanism as we have. While they have a European central bank which provides central bank resources to the euro zone, that does not include large economies such as Switzerland and the UK and that only deals with the monetary side, the fiscal side is still left with the individual Governments and the individual Governments have various view points. Some of them are as stimulative as can be, the UK has been blowing through money at such a rate that there's a real threat now that their Government debt's going to be downgraded, the Germans and the French have taken a much less aggressive view of spending. Plus not only have the European banks had an unhealthy appetite for some of our toxic assets, they have their own toxic assets.

When the Berlin wall fell and the foreign former soviet block satellite countries developed a capitalist economy, clearly their banks and their structures were relatively immature. They saw startling levels of growth much of it on borrowed money and it became very common not only for businesses but for home owners in Eastern Europe to borrow their credit needs from Western banks, so now they have a foreign exchange crisis. A very high percentage of Hungarian homeowners have their mortgages denominated in Swiss Franks, so while we may have trouble collectively paying our mortgages, at least our debts are in dollars and our income is in dollars. They have a problem because they have borrowed a hard currency which has appreciated considerably versus the Hungarian Floret so that literally there's about a 25% currency impact. Most of the banks or all of the major banks in Austria are actually insolvent, they're all broke, they're all waiting for the Germans to bail them out and of course the German's are getting tired of bailing everyone out and basically said they're not going to bail everyone out this time. The Spanish banks in particular had an issue as well as the Irish banks with a home bubble worse than ours in terms of speculative home buying and home building. Unemployment in Spain now is approaching 20%. The Spanish banks also have loaned a great deal of money in Latin America, so their banks are in very shaky states and because they don't have as coordinated and frankly as aggressive as a policy as

we've had in the U.S., you had a sense that it's getting very shaky over there. Other Governments, particularly China and Japan have been relatively aggressive in stimulating their economy, the Japanese are of course with their lost decade, are kind of a poster child for how to do it wrong and they still struggle. They tried nearly a decade of zero interest rates and found that actually wouldn't stimulate demand and the specter of deflation and that's actually pretty dangerous for me on an economic perspective, is still abroad in the world. On page 4 you can see some of the indications, one of the things that is significant (in the upper left hand corner) which is the spread of differences in rates between Triple B or B AA, which is the lowest level of investment grade from treasuries and it's measured in basis points and these are actually in full percents, in hundreds of basis points, so what you see is even compared to the depressionary period, 1929-1931, credit spreads are at an astronomical level.

Basically the presumption in the market is virtually all corporations are going to go broke and as we see with some of our larger investment corporations, we're probably right, but that clearly is a worrisome factor because it's a measure of perception of risk in the market and that's probably the most striking change we saw from the pre-2007 period to the post-2007 period. Pre-2007 there was no belief that there was any risk at all in the market, you could lend anybody any amount of money and it would all be fine. Now in the post-2007 period, the belief is you can't lend money to anybody and have any chances of getting it back. So this is a huge impact on the return of economic growth.

On page 5, we just spent a couple pages talking about the Government because it has been extraordinary. There are a number of different programs that are out there that the Government has been dealing with, we all hear about TARP and TALF and all these others, but there are an enormous number of programs that are very targeted at particular aspects of the market. I think we've been very fortunate that the head of the Financial Reserve did his financial work on the depression and I think he had a real sense of what they did wrong and I know there's a lot of concern and we still have a probability of ending up in the 1930's type of depression. One of the things that I think reduces that probability even in spite of the enormous debt we're now dealing with is the fact that we've been there once and we learned something, we learned that tight money and balanced budgets are a bad thing. We learned that Government waiting for the patient to cure themselves is a bad thing and if anything, we've gone to a very activist level and of course right now the issue is, fight the fire today. Unfortunately we'll see that some of the tools that have been used particularly this stupendous, almost unimaginable increase in liquidity in the money supply which is probably necessary to deal with the mess we're in, is going to have some side effects going down the road in terms of inflation, in terms of the decline of the credit worthiness of the U.S. Government, particularly perceived outside the U.S., all of these are going to add to negatives, so when we're done with this, we're not in happy land again, all we have done is substitute one problem for another problem. I don't think that anybody that really understands the complexity of this will argue that much of this is necessary, not all of it was right, but they also were operating under basically extreme time pressure. I mentioned before that when the history of this is written 10 or 20 years from now, we're going to discover like the Cuban missile crisis, we were close to the end of the world several times, literally hours away from the financial system completely collapsing beyond restitution.

The financial stability plan here on page 5 is just a staggering number of things they're doing and again, not all of them are right, not all of them are going to work, but I think unless somebody has perfect foresight and can make decisions instantaneously, they probably have done a decent job of dealing with it. It will be interesting to see when our European friends get to the same place we are, how good a job they do dealing with it.

On page 6, TALF, which is a program that the Treasury and the Federal Reserve established to deal with toxic assets on bank balance sheets and this is not just commercial banks, but investment banks. One of the issues about this what some of the commentators have mentioned is there's been a lot of band-aids, nothing has really been done with the actual problem. We can give people money so that they can pay their bills, but the reality is we still have several trillion dollars worth of actual toxic debt. We sent a research note (to the Chairman and to Paula) suggesting that this TALF program represents a very interesting investment alternative, basically they're now going to deal with, what about this debt and they're focusing on an area called asset backed securities, they may include commercial mortgage backed securities and residential mortgage backed securities, which are obviously the 2 things that kicked the problem off. Basically what they're trying to do is get this off the bank balance sheets and what the Federal Reserve would do is give you money to buy it from the banks at a very attractive interest rate and you only have to put up 5-16% of the value of the securities you buy so there's about 7 times leverage here, so here's your chance to be a hedge fund. If you can participate in this, basically you can buy these securities at a very attractive interest rate, called LIBOR which is the London Interbank Offering Rate which is the lowest commercial rate of interest on the market. The borrowing you make from the Fed is non-recourse, the Fed can't ask for their money back, it's non-callable, so they're making you an unbelievable deal, you get the difference what the asset backed securities actually pay and you borrow at and with the leverage, if the spread between those 2 numbers is say, 200 basis points, you're getting a 20% return on your money. The Feds are basically just throwing money at these problems, they're trying to get this stuff off the balance sheets and they're now making, this something called Public Private Investment Program. We actually basically said, this is a very attractive opportunity for investors, while leverage is ordinarily a bad thing, in this case here because the loans are non-recourse, basically you borrow the money, but if it blows up, you don't have to pay it back, which is a pretty good deal. So it's an opportunity for pension plans to earn a very attractive return, obviously the risk is subsidized by the Government and the financing is subsidized by the Government, it's just one of a massive number of programs.

Let's talk a little bit about what's going on in the market. On page 7, what we've done here was look at all of the business cycles in the post-World War II period. The pre-World War II period is such a different world, it's not relevant, and the issue here is trying to forecast when the stock market rebounds, assuming we are actually going to get an economic rebound. Obviously if we are going to get into further economic difficulty or have no recovery at all, none of this matters because the period before the recovery is infinite if there's no recovery. Basically what that shows (in the yellow block) is, the equity market rebounds significantly before the economy starts to turn, the stock market leads the economy by 6-12 months, so there's some sense that the economy may start to show some improvement by the end of this year and obviously that's dependant on a lot of things. The economists generally don't believe, and they've been wrong before, that we're going to see continued decline, but we're rather going to see modest improvement in the market. If we assume that historically, looking at this data, the stock market starts to rebound before the improvement's visible, because the stock market's a leading indicator, it moves before, the rally we started to see starting on March 7, 2009, could actually be our rebound, in fact it's one of the strongest stock market rebounds we've had in recent decades. So there's a real sense that if we are heading for better economic times, a typical post-World War II recession lasts about 18 months, so this one if it started at the end of 4th quarter 2007, that 18 months period, assuming this is a typical recession which most certainly it's not, but if that timing holds true, it's about time for it to start to end and it's about time for the market to start to recognize it's ending. So what it shows is that if you want to recover some of the losses that

you suffered, not just you as a plan, but just anybody who's invested in the market, you have to be invested in the market before it becomes visible, by the time it becomes visible, most of the gain is over with.

We did another study that looked at when we did have a rebound, what percentage of the return happened very early in the rebound. What we found was for all 11 of the rebounds in the post-World War II period, somewhere between 20-25% of the total recovery in the market took place in the first 100 days. So before it was even recognizable as any kind of recovery, you've already gotten a 5th of it, which is part of the reason you can't time the market. The recession began officially December 2007, so 18 months would be next month. That's the typical post-World War II recession. They typical post-World War II recession, particularly in the early days what are called inventory recessions, people stopped buying things, people backed up on the system, people stopped making things, they started laying people off because there was nothing for them to do and we went into a recession. This one is different, this is a de-leveraging recession, what we had was a stupendous build up of debt and it's not in the last 2 years, it's not in the last 10 years, it's been going on since about 1985. If you look at how long it's been since individuals, companies, municipalities, Governments, you name it, was borrowing enormous amounts of money, it really started as interest rates started to fall in the early years of the 1980's. As interest rates fell, it became attractive for people to borrow and they borrowed. What happened in the last several years is not that we were borrowing more money, it's just the underwriting standards disappear, anyone can borrow any amount of money for anything and there's all sorts of stories in California where somebody making \$14,000 a year bought a million dollar house with nothing down and how they expected them to make even one mortgage payment is ridiculous, the mortgage payment for a house like that is probably about \$8,000 a month. So people simply lost their minds, they had bad incentives, they were incentives to generate loans, because they got paid for generating loans. Any compensation consultant will tell you whatever you get paid for you will do a lot of and if you get paid for creating loans, you will create loans and there were eager buyers for the loans because everybody wanted to buy these loans and people were making money securitizing them. I think it's important to understand that we're never going to go back to where we were in 2005, where we all were ridiculously rich and had money coming out of our ears, because that's exactly the kind of environment that got us into this trouble. In 2005, we spend 9% more than we made simply by borrowing and withdrawing equity as cash for our home mortgages. People refinance, take out cash, buy big screen TVs, buy SUVs, take expensive vacations, we're never going to go back there again because the system is just not going to let us, so we've built an economy in terms of stores, in terms of everything, that requires an unsustainable environment to survive. That's why you see all these empty stores, these shopping centers closing down, because literally, we've built a retail environment that can only sustain itself by an extremely destructive economic environment. We're not going to be able to borrow money and spend, in fact, we're probably not going to be able to borrow as much as we make, because we're going to have to pay down the accumulated debt, we're going to pay more in taxes or have more silent tax because of inflation to deal with money that's been spent fixing this problem. It's going to take 10 years, we talked about the lost decade that the Japanese had, we may have a lost decade.

On page 8, this is again looking at the post-World War II cycles, there have been 11 complete cycles, we apparently have started a new cycle starting on March 9, 2009. In the first 31 days of that cycle, the market was up 26.6% so it gives you a sense of when the rebound happens, there's no time to think about, maybe I'll take some of the cash and put it in the market, you better be there. If you look at the total price change, that 26.6% that happened in the first 31 days is more than the complete price change in some of the cycles like cycle number 5 and cycle number 6, that went on for more than 2 years. So cycle 5 and cycle 6

which took place in the mid 60's basically didn't have as much of a gain as the first 31 days of this cycle, so it gives you a sense again of why it's hard to time the market.

Just continuing on page 9, the equity risk premium is a measure of how much you get paid for taking the risk of investing in securities versus investing in Government bonds. No rational person would invest in equity, which is dependent on a company doing well versus a Government bond which guarantees payment, unless you get paid something extra and extra is called an equity risk premium. Generally the equity risk premium in the post-World War II period has been relatively high, you got paid well for investing well for investing in stocks. The realized equity risk premium has been negative, it actually cost you money to invest in stocks, lots of money. There's a relationship between that and credit spread (the top chart on the right hand side) is the credit spread went through the roof, the equity premium took a nose dive. So as long as we have high credit spreads, meaning there's a very high concern of companies not being able to pay their debt, we're not getting paid for owning stocks. The last paragraph is also significant, the first quarter of 2009 was the worst quarter for dividends since 1955, companies have been cutting dividends to preserve cash, they've basically been doing everything they can think of to preserve cash.

Page 10 is fascinating and of course this list gets longer every day. This is a list of all the Government programs that have been put in place in the last 20 months to deal with the recession. You can see some of them are targeted to deal with, if you look at the Federal Reserve, where special purpose investment vehicles, one of them from Bear Stearns, from AIG that they had to bail out, all of these are in billions of dollars, which is becoming pocket change now. One of the things you can see is they've already spent \$4trillion and just to remind you, \$4trillion is just about equal to the inflation adjusted economic cost of World War II. They've committed for 3 times that much money, they've committed \$12trillion to try to deal with this and these programs just keep growing. Again I mentioned the TALF program and part of that is in here, basically what it's saying is, we will give you money to buy the securities off the banks so it gets them off their balance sheets to improve their capital structure, it gets the bad securities out of the banks, it improves their ability to have a solid capital structure and therefore will improve lending, that's the reason they're doing it. What they're trying to do is re-energize the banking system.

Dr. Leon Guerrero: You hear about companies wanting to pay back money they owe and the Federal Government is saying no, why is that? Terry Dennison: This is what is called unintended consequences. The companies got into trouble, the Government was afraid that the banks would fail, that would reduce the supply of credit, slow the recovery, so they gave the banks a bunch of money. The problem is the Government said, if we're going to give you a bunch of money, you can't do things like pay executives a lot of money and have big bonuses because we just gave you the money to keep you alive. Now they say, we're healthier now, we're going to give the money back so we can pay big bonuses, and the problem is, they're not as healthier as they think they are and the Government's concern is that they're not really recovered yet, they just want to get out from underneath the Government's thumb and they're still not now going to be able to make loans, they're not going to be able to stimulate the economy, so it just shows the unintended consequences. One of the issues, it's very important for the Government for TALF to work because it's the most effective way that it has come up with to get the toxic assets off the banks balance sheets, to re-energize and strengthen the financial system. Unfortunately, many of the people that are looking at making investments won't, because they believe that if you make a lot of money, Congress will take it away from you. Now the Government can't make a very important program work, because people aren't going to invest, if they make any money, the Government will just take it away. They just demonstrated that they're going to change the

rules, if they don't get the result that they feel they want to have or Congress wants to have, they're just going to change the rules.

One of the things if you look at this is just the enormous amount of money and on the next page 11 is a little detail on all these programs. There is a lot of criticism that's not well founded, that the Government is just pushing money out the door, doing anything possible without a lot of thought, I think the people who say that really don't understand how serious the problem was. It was very serious, the one mistake they made was letting Lehman fail, that's going to turn out to be a horrific, unbelievably expensive mistake.

On page 13, talking about what's been going on, there's some good news. House sales are improving, we might actually be coming close to the bottom on the mainland of house price declines. There are still problem areas, commercial real estate is a disaster, any real estate where the borrowing, and almost all of it is done with borrowed money, has to be refinanced in the next 2 years, is probably worthless, because there's no way to refinance it. Anything that's got a retail or hospitality component to it is in extremely bad shape. Inflation is actually negative if you look at it on an adjusted basis, the first ending March which was the first 12 month period since 1955 where we had negative inflation or deflation, as I mentioned before, deflation is very scary, that is what happened during the depression and the Government will do anything to avoid a deflationary spiral. Unemployment is up to about 8.5% at the end of March, we don't believe that it's going to hit 10%, we think it will cap out at about 9.5%. I mentioned that the stock market is a leading indicator, unemployment is a lagging indicator. Historically if you look at recessions, unemployment continues to rise even after the economy has turned around. There are some other things, obviously house prices are important, if there's some stability in house prices that's going to make people feel a lot more comfortable, the market not just in the U.S., but around the world has said things are going to get a lot better.

On page 14, if you look at real GDP, real means adjusted for inflation, the first quarter estimate we're showing down 6.1%, it was revised down 5.8%, but you can see literally the economy just fell off the table. The 5 year rolling average is now down to 1.5%, historically it's about 2.5% and we expect that we will see our first positive GDP quarter in the fourth quarter of 2009. Even if we get up to 2% growth by the first half of 2009, we need about a 2.5% to stop unemployment from going up, we need about a 2.5% growth in GDP to maintain employment stability. You can see that civilian unemployment rate if you go back to the early 1980's, unemployment actually hit 11%. Unemployment continued to rise even the economy turned around.

On page 15, talking about the economy, interest rates are very low, we've now achieved the most steep yield curve in the 2-10 year range in history. The yield curve is very steep, meaning short rates are very low, long rates are very high, long rates really measure the likelihood of inflation so high levels of long term interest rates indicate a strength in the economy, a steeply rising yield curve indicates strength in the economy, it also indicates that we're likely to see inflation down the road because people are asking for higher levels of interest rates to protect them against inflation as you go out 10 or 30 years. Ten year treasuries upon which many home mortgages are priced not just adjustable mortgages, but newly issued fixed mortgages, generally looking at the 10 year treasury as kind of a base right has risen significantly in the last month. So there's a real sense that interest rates are rising, 2 possible factors, one is the economy could actually be improving, the more worrisome one is you're running into people unwilling to finance the treasuries debt. That \$4trillion that's been spent already and the \$12trillion that's been committed, all that's going to have to be financed, there is no money, they're simply going to have to sell bonds or print

money to do that. Historically the largest buyer of U.S. Treasury debt has been foreign central banks and foreign sovereign wealth funds, particularly Chinese. They have indicated, partly based on political irritations with us, but also a financial concern that they don't have an unlimited appetite for treasury securities. They also are embarking on stimulation programs of their own and don't have quite as much money as they use to have. So what you're seeing is the treasury having to raise interest rates in order to sell their debt because ultimately you're going to have to pay whatever interest rate the market demands to buy the bonds. So we're starting to see rising levels of interest rates, the amount of money that has been committed to deal with this is about equal to our yearly GDP. The GDP of the economy in the U.S. is about \$14trillion a year which is not much different than the \$12trillion that they've already committed to spend. The total public debt nearly doubled this past decade reaching \$1.1trillion and the debt increased \$427billion in the first quarter, that's about a \$2trillion run rate and the numbers are just going to get bigger so we're likely in fact to see that public debt go up potentially 20-25% in 2009. Historically the sovereign debt of countries that get public debt up to 70% of their GDP are usually downgraded. One of the things that has been a shock in the U.K. is they have now been officially threatened with their Government debt being downgraded below Triple A. To ensure against default of \$10million of U.S. treasury securities for a year, it will cost \$40,000. That's 4%, so basically the cost of insurance on U.S. securities is 4% of the principal value. So the Government is now saying there's a possibility that the U.S. Treasury will default. Antolina Leon Guerrero: Who would make that statement? Terry Dennison: There's 2 things, one the credit default swap isn't a statement, it's what the market demands to ensure against default, the rating agencies are basically saying, at some point we may downgrade the U.S. Government credit rating, simply because the amount of debt is so high.

On page 18 on the bottom right hand corner, this is U.S. total public debt. First of all, you can see the stupendous increase. One of the things that's troubling is the portion that's in yellow which is inter-Governmental holdings, is relatively constant, so the public has stumped up that difference. At some point here, we're going to start to demand higher and higher interest rates and of course that's going to become a huge expense for the Government.

Joe T. San Agustin: From an investment standpoint, where do we go? Terry Dennison: At the end of the day we're going to have to do something, we have to invest this money. When we do the asset allocation we're doing forecasts of future returns, realistically, we're assuming that equities over the long-term will return 8.2%, that's close to what they've done historically, a little less. From 1926 on the return for equities was about 11%, that 8.2 is probably conservative but it's assuming a world is probably not going to exist. If we're going to spend a lot of money on environmental remediation, if we're going to do something about retirement, if we're going to do something about healthcare, the reality is we're probably not going to get that 8.2%, we might be lucky to get 5%, which means all of these pension plans are not going to meet their promises.

When you look at your performance, you're actually doing pretty well. When we look at our domestic equity managers compared to other pension plans, we are in the first percentile, we are in the top 1%.

We talked on page 16 about the growth of money supply, and notice M2 is the measure of the amount of money and money is not just currency in circulation, there's a lot of different M's used by economists to measure money supply. M1 is currency, traveler's checks, demand deposits and other checkable deposits, basically something that can be converted to currency. M2 is broader and it includes money market funds, savings accounts and time

deposits under \$100,000. One of the things that's striking is M2 has been growing at an accelerating rate, if you look at the shape of that curve, it's not growing flat, the 2nd derivative of that curve is positive. It's growing at an increasing rate and has been doing so since about 1960, so this issue of growing money supply right now M2, the real measure of money is 20% a year, because of all of this liquidity injection, but that's a fascinating number.

We talked on page 17 already of the fragility of consumers and again historically, the engine of growth of the global economy, the U.S. consumers were 25% of the global economy. So if the U.S. consumers are broke, it's not obvious what's going to get us out of this. Consumer confidence hit an all time low, it's a unit-less number, 50 is neutral, it fell to 25, it soared all the way to 26, it's a little higher than that today, but basically as a group we're not very confident about the future. Real disposable income grew a little bit but wages and salaries are trending downward. Consumer balance sheets, our assets are \$66trillion, our liabilities are \$14trillion, but it's the margin that matters, if you feel your house is declining in value, even though it's still worth a lot of money, you feel poor, it's marginal change, not the absolute number that matters. Antolina Leon Guerrero: What's the prediction going forward because I read other things that people now are going to be more risk diverse and even the so called rich don't feel good about spending. Terry Dennison: The term for it is called depression chic, rather than going out and buying an expensive dress, you go to a retail shop, instead of getting it in a fancy box at a name store, you take it back in a grocery bag. People are just not spending money, it has now become unfashionable to spend money. In terms of absolute loss of income and absolute loss of income power, this recession or depression has hit the rich harder than the poor. The rich have gone from being rich to being upper middle class. If you have \$100,000 house that goes up 20%, that's \$20,000, if you have a million dollar house that goes up 20%, that's \$200,000, so realistically the impact on the high end consumer, the one with the most discretionary spending, has been much greater. In fact if you look at house prices, it's the high end that's gotten clobbered, it's the very expensive houses. The cheap houses have fallen in price, but not very much, it's the expensive houses, because they never really were affordable to begin with, they were only affordable as long as the people lending you the money weren't paying much attention and a belief that house prices always go up so they believed that if you can't pay, they can sell the house for more than what you paid for it. As soon as that stopped being true, the house of cards came down and the de-leveraging has just started, there's still an enormous amount of consumer debt that's going to have to get paid off or written off or in some way disposed of.

On page 18 in the upper right hand corner you can see the chart of consumer confidence and it's a number that jumps around a little bit, but clearly it's been heading down to the nether land. Lower left hand corner we talked earlier about the paradox of thrift that we're all told that it's wonderful that we save money except the Government would rather spend it all. We actually looked at this number because a question arose on one of our internal calls, this does not include contributions to 401k plans, so it's probably a little higher than this.

On page 20, looking at what's happening in the market for the last quarter and the last 1 year, 3 years, the 1 year returns in the 30's pretty much across the board, they're actually down in the 40's for mid value, it's been very tough for value managers. The 3 year returns are annualized so you don't just multiply it by 3, you probably multiply it by 3 and a half because of the compounding effect, so basically the market's lost 50% in the last 3 years.

The charts on the bottom give you a sense of what's outperforming and the first one is the performance of large caps minus the performance of small caps, so if the blue line is above zero, large cap is outperforming, if it's below the line, small cap is outperforming. In this case, outperforming can be doing less badly, so we're not talking about absolute out

performance, we're talking about relative out performance. A couple of things that you see if we've had a long period of small cap out performance, if you go back, it's all the way to 2000, you see basically small cap is out performing large and there's a few little blips at the end, the very end, it's become a little indistinct, but we seem to be heading back into a large cap out-perform environment, large caps tend to out-perform in the markets doing well and small caps in the market doing poorly. The right hand panel is growth minus value and we can see for that same period when small did well, value did well. The thing that is interesting, in a calculus sense, if you sum the areas under those blue, the sum of the blue for growth is substantial smaller than the sum of the blue for value and that's consistent. Over the long term, value out performs growth, which seems perhaps counterintuitive, because if you're buying stocks with growing companies who's earnings are growing and sales are growing, shouldn't you make more money. But the reality is, people tend to over-pay for growth stocks and you're actually better off with buying stocks of companies that aren't necessarily growing as rapidly, but you can buy cheap. If you look at that same process on the left hand side, and you go back to 1983, the sum of the blue growth if it were a large cap, is larger than the sum of the blue for small cap which is the reason we have more large cap than small cap. Historically, we've tried to be roughly balanced in growth, between growth and value, we don't think either one now is particularly attractive versus the other.

Looking at page 21, you can see that for the 1 year, just horrific numbers down in the 30's and 40's. A couple of interesting things, NASDAQ which again was the tech stocks, the dotcoms which have done so poorly in 2000, 2001, actually were the least bad performers for the 1st quarter. We did see a tech rally in the 1st quarter and tech stocks are very dependent on capital spending, it's not whether you or I buy a computer, it's whether companies buy 10,000 computers. That's a positive indicator, basically tech stocks doing well could be seen as a positive indicator going forward. Predictably growth which is heavy tech oriented, large cap growth, Russell 1000 are down only 4%, mid cap growth, very heavily tech oriented, down only 3.4% versus the corresponding on a value side which were down multiples of that.

Page 22 looking at the sectors as you might expect, the ghastly negative numbers are all in the financials, the banks in particular, you can basically buy, probably not true, but it was probably approaching a period where the value of Citigroup was smaller than the value of the New York Yankees, it was probably never actually true, but they were definitely converging. You can see for the year, the large cap financials and the Russell 1000 were down 60%, in the value index which is heavily financially oriented, down 60%, the growth sector down 51%, but some rebounds, there's been a bit of a rebound in this when Citibank got down to a dollar, I suspect you had a bit of value hunting in there because it doesn't take much if you're buying one of the largest banks in the world for a dollar a share, the idea you could probably easily double your money. Similar small cap financials doing very poorly, pretty big rebound again in the 1st quarter which I think is positive.

On page 25 looking at the non-U.S. stocks, we talked about the problems in Europe, if you look at the Europe XUK and the UK is not much better, they were actually performing worse than the U.S., so this is truly a global recession. Europe XUK was down more than 50% for the year and down 16% for the quarter, the thing that's interesting is that emerging markets have turned a corner, they were actually up 1% as a group and the small cap for the quarter actually did better than any of the other categories, except the emerging markets. So we're beginning to see a bit of a change in the non-U.S.

On page 26 looking in more detail on the emerging markets, remember the BRIC countries, Brazil, Russia, India, China, if you look at their performance, again bad for the year, but on a

quarter basis, India down only 1.5%, China actually up 1.3%, Russia up 5.9% and Brazil up 12.5%. So for the year it was poor, we're beginning to see the rebound there.

Page 27 looks at the bond market, looking at the high yield, at the bottom down 20%, high yield trades a lot like equity. One of the things about high yield, while it looks very undervalued based on historical default rates and historical recovery rates, it probably is relatively fairly valued, because we're seeing much higher default rates than expected and recovery rates much below historical levels.

Page 29 is DC, there's been a lot of business going on with stable value. Stable value is a composite asset class, it basically consists of a bond portfolio and a promise from an insurance company that with the value of the bond portfolio kind of behind them, they will guarantee, that's what stable value means, the value of participants holdings. So it's an asset class that can't lose value except for the likelihood that did happen in the 80's of a default by the insurance company. What's happened now is some of the bond portfolio, those that are underlying stable value, have turned out to have nasty things in them and there's a statistic that's measured often, which is the ratio of the book value to the market value and the promise of the stable value is \$100 and the market value of the bond portfolio is \$92 or \$90, at some point there's a trigger and it allows the insurance company to walk away from the guarantee. It is unusual, historically, it's never happened, now because of these bond portfolios having issues, we're starting to see, literally the stable value options, cease being stable value and what happens is that in order to have a quality where everybody gets treated alike, they basically dissolve the stable value fund and you just get the market value of the bond portfolio, so instead of the bond portfolio, you get the \$92 or the \$88. It varies by provider, we don't know of anything presently that's an issue with yours, but this is becoming very common. What's happening now is the insurance companies who have problems of their own, they're very significant buyers of real estate securities and they have liquidity problems of their own and they're basically saying they're not in the stable value guarantee business anymore. This role is called a wrap provider, they're providing an insurance wrapper around a bond portfolio, so we might start to see in the same sense of issues around securities lending, now we're seeing similar type issues around stable value and despite the popularity of stable value, that could be an endangered species, at least in the short term.

(Page 36) Obviously commodities have been clobbered by the economic slowdown, you saw the price of oil go from nearly \$50 a barrel down to \$140 a barrel as well as huge drops in industrial metals like copper and lead, agricultural commodities, live stock, you name it, everything went down. One of the things that's interesting and precious metals probably operate differently than other things, but if you look at the industrial metals, they actually popped up a little bit and that's significant because if you're going to have a real economic rebound, where industrial production increases, where all of a sudden there are new orders, one of the most sensitive measures, the binoculars that see furthest into the future, are probably looking at the raw materials. If you're going to make more of whatever it is you make, you have to buy the stuff you make it from. So in terms of leading indicators, the reality is that's an interesting statistic because what it indicates is that people are beginning to put upward pressure, buying pressure on basic industrial commodities and perhaps we're seeing a rebound in economic activity. Now the thing that's tricky about that is of course this is a global business, this all could be in China, not necessarily in the U.S., on a global basis, we're beginning to see more demand for the things for which things are made.

A lot of economists believe the natural price of oil is probably about \$70 a barrel, that's really a balance between true supply and true demand, anything above that is speculation. There

were a lot of pension plans that got the commodities bug really bad and lost half of their money or in some cases, all of their money investing in that, but I think the natural price is probably in the \$60-\$70 range, obviously that's dependant on demand, if we start to get viable electric cars and all of that, it's going to have an effect on demand. If we don't do something to protect energy efficiency, that number is going to get more and more expensive, because there's only so much oil.

Joe T. San Agustin: Would you suggest a change in or reviewing our asset allocation? Terry Dennison: We've made some pretty good decisions on asset allocation. It's unfortunate it took so long to get into the emerging markets, but I think the fact we held off on the real estate is a good thing. Anytime you're doing asset allocation, you are inevitably looking into the future, you're asking yourself, what is going to be the return of various asset classes, what's going to be the volatility of various asset classes, because what we want is to find the ideal combination of risk and return. We want to get the highest return for a given level of risk or the lowest risk for a given level of return, so we're forecasting risk, we're forecasting return and diversification works because of correlation, so we're also forecasting correlation. Historically, our vision of the future, how far out we could see wasn't as far as we thought, but it was fairly far. In 1992, we could assume that for the next 10 years it would probably be pretty much like they were then. In 2003, we could guess at least for a little while, they'd look like 2003. The problem now is I have no idea, our horizon is literally a matter of weeks. Historically, you could invest in a bond that was high in the capital structure and be assured that if the company went broke, you would have a preferential, position in bankruptcy, but not anymore, they changed the rules. We have no idea what the tax situation is going to look like and taxes are very important to companies, we have no idea what the interest rate environment is going to be, we don't know what the growth is going to be. We hardly know anything about the future, in the absence of any other information, until we can see something, we might as well continue, however little confidence we have that the future will look like the past, in the absence of information, probably the best thing to do is operate as we did in 2008 when we did the asset allocation and assume that the future will look something like the past. The future will not look like the past, unless we know what the future is going to look like, we have no idea how to react. I see less growth, lower profitability, lower returns, probably more risk. People use risk and uncertainty synonymously and they're not really the same thing. Risk is the degree of volatility you can see, uncertainty is the inability to see. We always knew there was risk, we underestimated the amount of risk, particularly in the mid years of this decade. House prices always went up, bond prices always paid, stock earnings always paid, we misjudged the amount of risk, the problem now is uncertainty, we don't even know what the risks are. Unless someone's got a working crystal ball and can actually lay out a creditable scenario of what the future world's going to look like, I don't know what we'd do but just stay the course.

The other thing, there's something call centripetal force which is a force in physics that basically causes things in general to stay the same. Engineers use 2 words to describe systems, one is called dynamically stable and if you imagine a marble in a sombrero turned upside down, it will rattle around, but there's a central tendency. A dynamic unstable system is a marble standing on top of a sombrero that's upright, which means any movement at all tends to accelerate. There's a tremendous amount of stability, built into the system, in fact that's what the Government is trying to do is maintain stability. If they're successful without too much collateral damage, without too much unintended consequences, the scenario that we assumed in general is probably going to come out and if it doesn't, we just have to adapt, but that's why we get together, it's going to be obvious, the world's going to be fundamentally different. You can say that having lost less is great now, but we've gained less in future times, but there's an asymmetry that comes from the way the numbers work that if

you lose less when the market's down, you don't need as much of a rally to get back to where you started from, because percentage return isn't wealth, it's not benefit payments, it isn't money, you have to apply that percentage return into some amount of money, that's why this works. If you lose 50% of your money in one period, it would take you 100% return to get you back to where you started from. If you lose 25% of your money in the period, you would only need a 33% to get back to where you started from. So being more conservative and losing less money puts us in a better position to at least get back to where we started from. It would have been nice had we made a big pile of money when things were going well, because then we'd be playing with the house money, but the reality is we are where we are, but at the end of the day, we can only take what the market gives you, we all want those lines to go up, but the reality is, we can only invest in things and we can only take what the market gives us. We try to balance risk and return as well as we can, we don't take foolish risks trying to pursue a one chance in a million, we don't buy lottery tickets or the security equivalent of lottery tickets, the reality is you pay attention to liquidity. There are a lot of pension plans that have big liquidity problems, those that invested in alternative investments, private equity, non-securitized real estate. We lost money in real estate, but if we wanted to get out of real estate, we'd be out of real estate in 3 days. If you have invested in buildings or shopping centers, you can't sell them. If you're in a securitized real estate program, you have to get in a cue to get your money back, meanwhile you still have to pay your benefit payments, you still have to pay expenses, there are a lot of pension plans that are selling whatever they can sell, even the things they want to sell the least, because they have to sell what they can sell.

One of the agenda items is to establish a range, what we've given you is some data about establishing a range and what the range gives you is a little bit of latitude to kind of tune it. One of the things you have to bear in mind and any pension has to bear in mind, is unless you make a big enough move, all you're doing is incurring the headline risk without actually generating any real money. What we've given you is based on a logical framework, it's basically saying we have a target and we want to have the ranges be volatility based, if we want to expand that, we can.

The emerging markets entered the recession later than everybody else, fell the least, have recovered the quickest. There's an index called EAFE, which stands for Europe, Asia and Far East which established developed markets and it's either 20 or 21, depending where you put Malaysia, everything else is emerging markets. It's countries with less mature economic systems, less mature political systems, less clear shareholder rights, generally lower levels of wealth, what it represents is a different kind of investment. The classic argument for emerging markets is rather the developed markets where particularly in Europe, the political emphasis is redistribution, basically taking from the rich and giving to the poor, in emerging markets the political imperative is growth because they don't have any money to give anybody, their object is to grow. If you look at the Chinese, the Indians, the Russians are a special case because of the tremendous influence of oil and diamonds in their economy and the Brazilians, who basically have done a lot of things right, they make airplanes, the Brazilian airplanes and the Canadian, Canada Air are the typical planes used in the regional airlines, they've basically met their energy needs, with indigenous alternative fuels, they make gasoline out of sugar cane, they've done a lot of things right. It's a big enough market where local demand cushions them from the ups and downs of the global economy, they're biggest export other than airplanes, is coffee, low end coffee, but the reality is, they've done it right, they're up 12% for the quarter. Then the question is what are the next ones, clearly emerging Europe, Czech Republic, Croatia Poland, Latvia, Lithuania, Estonia, virtually all of South America, say Brazil is emerging market, some of them are messes, Peru and Ecuador are messes, some of them like Chile are doing just fine and other places in Asia. There are

ranges in emerging markets, there's high-end emerging markets in the BRIC countries, they are what are called the frontier emerging markets, the places where truly you love the stocks, but you wouldn't drink the water, you wouldn't even go there. The reality is it's easier for a small economy to grow at 10% than it is for a large economy to grow at 10%. The U.S. couldn't grow at 10% basically no matter what happened, there's too much inertia, a lot of these more early emerging markets could easily do that. Everybody is interested in what's called inward economic investment. China didn't do this on their own, there was tremendous investments in China, particularly for the west. Everybody now is interested in being attractive, everybody is trying to get this economic inward investment because that's how growth happens, but if you look at the countries in Europe, they're trying to figure out how to change their tax policies so somebody doesn't get rich, they don't have any money to re-distribute, their object is to create wealth. We have to adapt to the circumstances we see on the ground.

(End of presentation)

Note: Because not all Committee members were present, the meeting ended at this point.

Defined Contribution Plan

11:15am-12:15pm DC Plan – Quarterly Performance

1:30pm-2:15pm DC Plan – Search Report for Replacement of American Bond Funds of America

2:15pm-2:45pm DB Plan – Funding of the Following Managers:

1. Thomson Hortsman & Bryant – Not Yet Funded
2. Cornerstone – Partially funded
3. Security Capital – Partially Funded

3:00pm-4:00pm Wrap Up/Other Items

Respectfully submitted,



STEPHANIE A. HERRERA
Recording Secretary

Affirmed:

Wilfred P. Leon Guerrero, Chairman

