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**RETIREMENT FUND**  
 STABILITY • SECURITY • REWARDS

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**Quarter Ended 9/30/10 Performance Meetings  
 & Annual Manager Reviews**  
 December 15, 2010  
 Retirement Fund Conference Room

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- Joe T. San Agustin, Chairman, Board of Trustees
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- Gerard A. Cruz, Member
- Wilfred Aflague, Member
- Antolina S. Leon Guerrero, Member
- George A. Santos, Member
- Katherine T.E. Taitano, Member

**Staff Present:**

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

**Other Present:**

- Terry Dennison, Mercer Investment Consulting
- Doris Flores-Brooks, Office of the Public Auditor

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**9:00am-9:45am Economic & Capital Market Development**

Terry Dennison: You have a book in front of you with a clear binder that's thinner than the rest, this is what we're going to go to, it's become too cumbersome to thumb our way the bigger books, the

bigger books are there for your reference. What we did is we picked out of the big books what we thought was the most significant, in fact this book is that one, it has got both the, it's labeled The Government of Guam Retirement Fund 401(a) and 457(b) Plan. This is everything we are going to cover in the next 2 hours.

If you look on page 2 and I'll be able to short circuit a little bit of this. (We can look at the big one if you have specific questions). A little bit of market news and I would remind you while we continue to see issues about how well the economy is doing although generally the trend has been a little bit more positive, you don't see as much discussion of a double dip recession, you don't see as much concern. Despite the modest increase in unemployment which is probably the most difficult financial, economic signal, just to remind you that the markets don't equal the economy. While the economy has been doing badly, the markets have been doing great, in fact I believe today we hit a 2 year high on the Dow Jones and obviously because the Retirement Plan is significantly invested, not just the DB Plan, but all the Retirement Plans are significantly invested in equities, we have been creating wealth at a pretty good clip here. It's important to remember ultimately while the market can behave in a manner dissimilar from the economy, they ultimately begin to come together, so we continue to need to see some real improvements in the economy.

If you look on page 2 in the upper left hand corner we have the GDP growth. Just a couple of comments here, one to give you a sense of how bad the recent past has been, if you look at the red line that's labeled 5 year average which is 90 basis points, that's the average for the last 20 quarters of GDP growth, annualized GDP growth. Less than 1% is a pathetic level of growth. You need about 2.2% GDP growth to maintain stable levels of unemployment because the labor force is growing at approximately that rate and that required rate will decline as the labor force declines, as people retire either voluntarily or involuntarily, but the reality is we're not growing at a number anywhere like what is necessary to improve the unemployment picture in the short term. Another comment about that more relevant for you than it is for the U.S. that if your Government debt, if your interest rate on your Government debt is higher than your GDP growth, you're going to go bankrupt. If you aren't creating wealth in your economy equal to the interest that you are paying on your Government debt, you're going to go bankrupt, maybe not next week or next year, but soon enough.

Doris Flores-Brooks: So where is the U.S.? Terry Dennison: Well right now the Treasury is borrowing money... the 10 year is 311, 312 in that range, but we can borrow short term for 90 basis points. I mean it's very low, but if you look at what you're seeing really in Europe, other than Germany, the Netherlands and even France, many of those countries are now paying more in interest to borrow for their Sovereign debt than their GDP growth, which means they're all going to go bankrupt. There's concerns, we've seen even Germany's bond yield demanded by the market rise. We see continued instances although they're

little bits of fluke, where the risk free rate even in the U.S. isn't Government debt. Right now Microsoft can borrow cheaper than the U.S. Government can because Microsoft is a better credit risk than the U.S. Government, but outside the U.S. this is becoming increasingly frequent... From our perspective, this causes some interesting theoretic issues, because often in the process of things like asset allocation, we use something called the risk free rate, which in any particular economy is the rate that's deemed to be either risk-less or the lowest risk. Historically it's always been the Sovereign debt of the Government, but if we now have a situation where companies can borrow cheaper than the countries that they're in, this causes some theoretical problems for how we design portfolios and there are a lot of companies in Ireland, a lot of companies in Spain that can borrow cheaper than the Government in the countries they are in can borrow. I mean, not an occasional fluke that gets a little headline in Bloomberg, but routinely now we're seeing the Sovereign debt of many countries no longer being the risk free rate in those economies.

You can see on the right hand side of that top graph we've now had 5 quarters of recovery although very, very modest. If you look at the depth of that negative bar down in the 4<sup>th</sup> quarter, down 7%, you would have expected a much stronger rebound. The comment that I made earlier about we don't seem to be able to develop that level of sharp rebound. Going over to the right hand side looking at the Purchasing Manager's Index and this is a pretty sensitive measure of what's going on in the economy, because basically what drives the economy are final sales. Inventory building, in fact if you look at the components of GDP Growth, we're seeing again significant inventory building in that number, true growth is probably less than 1% that we're seeing inventory building in that number, but the Purchasing Managers Index has improved significantly; the 50% line is break even for manufacturing, the 41.2% is economic break even, so we should be seeing the economy grow, because supply managers are seeing orders significantly above that level.

Interest rates continue to be very, very low, although we did have a spike as Gerry (Cruz) eluded to, a spike in Treasury rates because of the concern about quantitative easing version 2... Gerry Cruz: Can you explain that? So we're about 1/8<sup>th</sup> the way through that process and they're targeting the 7 and the 10 year, so you would expect those rates to come down, but in fact those rates have gone up almost 50 basis points in the last 3 weeks. Terry Dennison: Exactly and the reason there is and this is one of the problems with driving the economy, I've heard the perfect description of driving, trying to manage the economy, imagine driving a car where when you turn the wheel somewhere in the next couple of blocks it probably went to the direction you turned the wheel, but sometimes it didn't and you stepped on the break or the accelerator, sometimes it would do nothing and other times it would move very abruptly, that's what trying to drive the economy is like. What Gerry (Cruz) has observed is clearly they're trying to drive down interest and what I think and what many economists tell me is probably a misguided belief that this will produce demand and what it is doing is helping reduce the value of the dollar and again there's a

strong constituency that reducing the value of the dollar is hurtful to the economy, but the sense is it will help exporters unless other countries simply devalue their currency, which they're doing. Gerry Cruz: So it's a race to the base. Terry Dennison: It's a race to the bottom, but the problem with what happened with QE2 is yes it increased the demand or the supply rather, I'm sorry, reduced the supply which should have increased prices and lowered interest rates, but it also produced a belief that inflation is now coming. So what happened is they're now starting to see exactly the reverse of what they wanted to happen, because of inflationary expectations and part of that is driven by the declining value of the dollar because there's a component of inflation that's based on commodity prices. If you look at how gold and oil which are our global economy priced in dollars behave, the rise you see in oil and gold have something to do with demand, but largely because they're largely impacted by the value of the dollar against in which they're measured, so when the dollar loses value versus other currencies, gold goes up and oils up and that increases inflation. So in effect and this was the point that a lot of economists outside the U.S. made including a lot of central bankers outside the U.S. made that the Government tried to drive down interest rates and have had exactly the reverse effect, that interest rates have risen because now concerns about inflation.

Gerry Cruz: Has it created an opportunity on the long end then if the target is the 7 and 10, is there an opportunity beyond, going into the 15 and the 20 year... Terry Dennison: Well remember, if the rates start to rise at the long end... Gerry Cruz: But you created almost a hump... Terry Dennison: Yeah, you are beginning to twist the yield curve, but you're also seeing rises in the 30 year rate and that is, in investing long of course magnifies your gains and losses with changes of interest rates. Rates are so low now, the balance of risks is very negative for owning bonds because rates can't go below zero and they're being artificially held down by Government action, not just in the U.S. but in Europe also that is probably unsustainable. You just can't have the central bank load up their balance sheet with all this without ultimately causing other problems in the economy. Right now the balance of risks owning bonds is very negative. Gerry Cruz: So what I'm hearing is we're in the process of creating a Treasury bubble. Terry Dennison: Yes, we're well past the point of creating a Treasury bubble, there's a huge Treasury bubble. Gerry Cruz: So when we start to unwind this quantitative easing process we'll see rates shoot up. Terry Dennison: You're going to see rates shoot up a lot. Gerry Cruz: Quickly. Terry Dennison: And of course that would extinguish any modest rebound in the housing market and we're not going to see any real movement out of this recession or broad reduction on unemployment until you fix the housing market. Gerry Cruz: A new longer recession with no more triggers to... Terry Dennison: No more triggers to pull, no more ammo, whatever analogy you want to use, we're in a stuff spot. Gerry Cruz: Isn't quantitative easing the process by which the Fed buys its own debt, kind of the last straw before the apocalypse? Terry Dennison: They're monetizing the Government's debt.

In terms of unemployment I looked today at that statistic I've mentioned before called U6 which the Bureau of Labor Statistics publishes, it basically is a measure of under employment, there are people who are looking for work, meaning they are looking for jobs within the last 4 weeks, are working involuntarily part time and would like to work full time. That has been between 16 and 18% of the workforce for the last year and has shown very little movement. You look at the graph, of course we have the published unemployment number, the U1 number go up to 9.8%. So, we're not going to see any improvement on unemployment for quite a while. Gerry Cruz: Not in housing either. Terry Dennison: Not in housing. Gerry Cruz: Back when commodities, actual commodities, grain and wheat became, we were just over-run, they had to slash, burn fields of corn in order to drive up prices, do you think that might become an option for homes where they just... Terry Dennison: They're already, in the area east of Los Angeles the so called Inland Empire, using Chamber of Commerce designation basically a pretty much empty land, they're already bulldozing houses, shopping centers, entire housing developments because it is too expensive to just maintain these houses, you can't have a swimming pool full of water without malaria, you could have literally infestations of nasty things. Realistically these houses, some of which were fairly shoddily built to begin with or to some degree incomplete, just take them off the market, writing them down as zero. Terry Dennison: The land value is still not zero, but realistically they've already written down, all we're doing now is consuming ongoing expense. They're just basically throwing in the towel on them, get them off the market. You've got a situation very similar to what you have with the Savings and Loan crisis in the early 1990's where basically house prices in places like Denver simply could not go up because it was such enormous glut of unsold houses and that has not only an impact on the economics, but also the labor mobility; if you can't sell your house, you can't move to another job. So, it's very important to get house prices to go up and one way to do it is simply reduce the supply overhang. We've gotten ourselves into a real pickle, of course everybody believes there's some way out of this, but there's a jam you can get yourself into where you can't get out of it and I think places like Greece, I was going to talk a little bit about Europe, the bargain of the Euro was mis-understood or abused. The Euro allowed countries to borrow at German interest rates, which would only work if those countries had German activity. You can have Southern European la dolce vita and borrow at German interest rates because that will blow up too and that's what's happened.

If we turn to page 3, you can see the unemployment rate in the upper left which is now up to 9.6. The red line is the employment population ratio which we see really was in the mid 60's as long ago as the turn of the millennium, it has now fallen down nearly into the mid 50's and is unlikely to go back up again because you now got not just the leading edge of the baby boomers, but getting in to the fatter part of the baby boomer wedge hitting retirement age. So that's going to be a significant impairment to future growth potential because there's simply not going to be the workers and because the construction business was

the big draw for immigration, legal and otherwise, we're actually in many places in the U.S. seeing net immigration because the construction jobs which were a strong draw, they didn't check credentials very closely and it wasn't very complex work, you didn't need to speak much English, these jobs are all gone so people are going back across the border we're going to run into a situation where even if final demand improves, there's not going to be enough workers around to be able to generate the kind of gross we need going forward.

One more thing on page 3 in the upper right hand corner, again a bit of paradox, consumer sales have rebounded although consumer confidence stays low. So we're back to retail therapy, but it's like we know we won't be able to pay the bills.

Page 4 talks about the housing which again is an enormous component of GDP. The spectacular levels of GDP and economic growth we had in the mid 2000's were all due to construction, which was obviously in far and excess of what was appropriate, but clearly I think it's well understood that until construction gets back on track, we're not going to see the levels of growth necessary to bring unemployment down. Doris Flores-Brooks: But is it even the next year or so? Terry Dennison: No. Doris Flores-Brooks: Every time I hear it, it continues to get extended another 2 years. Terry Dennison: It's moving actually faster than the calendar pages. This is why they're tearing the houses down, one, it cost so much money just to have them, they're already worthless and it cost money to try to maintain them, but you have to get the supply down, that was the lesson for the Savings and Loan crisis in places again like Denver where house prices couldn't go up because there was just this enormous supply of unsold houses.

One statistic I did see yesterday is that the percentage of houses nationally that are under water, meaning their market value is less than their mortgage, has been shrinking which is also important, because if your house is worth less than you owe, one you can't move, second you can refinance it and secondly, your attachment to that house at least as a business proposition is pretty weak. So that's probably even more important than getting construction going, in fact, there's probably a condition precedent to getting construction going, you're not going to people buy houses until they can sell the house they have and they can't sell the house they have if it's worth less than what they owe. Rosalia Bordallo: So why don't they move? Yes, you're making the point that they can't move because they have to sell this house, but realistically and it does happen, they just walk away and isn't it better to just walk away? Terry Dennison: Yes, you do see a lot of people just walk away, the problem is, they have capital invested in that house. You can say, we're never going to get it back, so some cost, forget it, it's no longer a decision factor, but there's a psychological thing, most people who own a home, their view of what it's worth is the highest number they've ever heard in a cocktail party plus 10% and they are loathed to sell it for less than that. Unless the traditional American optimism that this too shall pass has gone too in which case we're in very serious trouble, people say, well in 18 months it will be better. They're not just giving away, they own the

house, they basically have this huge leverage that if the house gains in value, if it gets above the amount of the loan, that money is all theirs.

People talk about hedge funds as being risky, 20% hedge ratio, 20 times leverage, ordinary houses are 20 times leverage, 10 times leverage. So people say hedge funds are really risky because you've only got 10% of the money invested, well that's a typical house mortgage. Most people figure if house prices come back, any gain is there's and it will be forever going that gain. Wilfred Leon Guerrero: When did this thinking come about where if you buy a house and sell it in 5 years time or get a loan on the equity... this just hit me not too long ago of what people are doing, buying with the idea that in 5 years time they're going to sell it. It use to be, you buy a house and live in it until you die. Terry Dennison: If we were all wise or not, we would have recognized this as one of the signs that the end is near. There was in the middle 2000's a website called "condoflip.com" and basically you could buy a condo before the building was built, before the building existed, it was just nothing and sell it for twice as much money while the thing still wasn't built and this was basically like an Ebay for people flipping condos and it was just a giant casino.

Wilfred Leon Guerrero: I wonder why people worry about the value of their house, it doesn't make any difference to me if it goes up or down. Terry Dennison: The psychology change from a house being a place you lived to a place that was an investment that you lived in, somewhere probably in the early 2000's and along that came this changing of the mentality of financing. In fact, I'll take 5 minutes and get a little deeper into some financial theory. You may have heard, because he's become very well known now, a deceased economist named Hyman Minsky and actually you hear something called "a Minsky moment," Hyman Minsky said there's sort of 3 phases of economics and you can use the house as an example. You're thinking as you buy a house and you take out a loan and you have enough money to pay the principal and the interest, that's very healthy, that produces growth, that gives people an opportunity to live in and take advantage of a house before they have all the money necessary to pay for it. The second stage which is getting dangerous, is you buy a house and you can only afford to pay the interest, you can keep the principal from going up, but you're basically just paying the interest and what you're hoping is that the house appreciates in value. The third stage which in Hyman Minsky's view of the economy and has been proven is extremely dangerous is where you buy a house and you don't actually have any money to pay the interest let alone the principal and basically you keep borrowing against the house to pay the interest and there the hope is it's the lottery ticket, that somebody will buy the house from you and you will be able to pay off the accumulated interest, the accumulated principal and take some money out of it. We just got to that 3<sup>rd</sup> stage in about 2006 and 2007 where people were buying houses and because it was such an economic incentive for people to create and package mortgage debt, you could buy a house, I mean there's these stories that surface now about people who had no income who bought a million dollar house with nothing down and there was no creditable possibility that

they could ever make a payment, they couldn't make the first payment. Remember mortgages have defaulted because the first payment was never made was huge and this is that 3<sup>rd</sup> stage. We have now rolled back, it's now very difficult to get a loan if you can't clearly pay not just the principal and the interest, but have a substantial margin. So the pain that we've seen in the mortgage market, the housing market is because we've moved away from the sort of lottery, houses never fall in value, that was the first fallacy. A house can fall in value, but houses is a class across the country can't fall in value, well when the do, all of these 3<sup>rd</sup> stage Minsky moments of scenarios collapsed and that's how we ended up with all these bad mortgage backed securities, all these banks going broke.

Incidentally I saw today that the Treasury sold its last remaining \$45 billion dollar stake in Citibank and made the tax payers \$12 billion so when you hear people say, the Government bailed out these banks, the Government made about a 20% rate of return on these loans. Gerry Cruz: And they still own Warrens. Terry Dennison: They still own Warrens, but the sold the direct stock and these were 2 fantastic investments for the Government. Gerry Cruz: MGM as well. Terry Dennison: Yes. Basically all these deals, you go back Lockheed and Chrysler, they've always made money on these deals.

The house situation, your view on housing would have been viewed as anachronistic in say 2005. As I said probably for 2 years here, we were very fortunate that it blew up when it did. Another couple more years of living like we were living, there wouldn't be enough money in the world to fix it, we'd be back to the 16<sup>th</sup> century. I saw an interesting statistic that at the rate the U.S. Government is borrowing money in like 20 years there won't be enough money in the world. Literally, there's a certain amount of money in the world, there won't be enough money in the world for the U.S. Government to support its debts.

Turn to page 6, again the economy is not equal to the markets. Often it's believed that the markets are anticipatory, they're not concerned with the present, they're focused on the future and this would be positive because the markets are basically saying, all is going to be well, but sometimes the markets are wrong. If you look at the returns for the last quarter, year to date and one year, very positive numbers, pretty much everything in the equity markets was up over 10%, but you could see the damage that was done because if you look at the 3 year numbers which are numbers which are basically starting in 2007, how much those losses were because despite basically 2 years of very positive results in the stock market, they're still negative so the hole we dug was pretty big.

I've always pointed out on the bottom, looking at large versus small, we're back to being pretty much neutral. Large and small are doing about the same, it flips a little bit from quarter to quarter, but we're really continuing on the right hand side where growth stocks are doing better than value stocks.



Turn to page 7 looking at the performance of the indices, obviously for the quarter everything was looking terrific and obviously 4<sup>th</sup> quarter is looking even more terrific, but if you look, the sweeter spot was Mid Cap. Pretty much Mid Cap across the board did better than Large (Cap) and Small (Cap).

(I'm not going to spend a lot of time on pages 8, 9 and 10 unless somebody wants me to. This is looking at it on a sector basis). Doris Flores-Brooks: Which is the most promising sector? Terry Dennison: It varies from time to time, but in Large Cap it is Telecom Services and Materials, which is interesting because Materials is very strongly correlated with the economy. Materials are stuff you buy to make things and they're not making it unless they think they're going to be able to sell it, so that's pretty strong. If you go to the Mid Cap, Mid Cap is a little broader, consumer discretionary and if you think about it, 2 years ago consumer discretionary was dead, people weren't buying anything they didn't need to buy. Telecom, Materials and IT, it's a pretty good market for tech stocks. Healthcare and Consumer Staples which were the places to be 2 years ago, this is the site, the rotation of the market. And finally you get the Small Cap, again, Materials and IT. Technology continues to roll along, but I am pleased by the materials because that indicates and this is less speculative, again you only buy cement and copper, steel and those sort of basic materials if you think you're going to make something you're going to sell. If the market was entirely dominated by consumer discretionary, luxury goods, gambling stocks, you'd have to wonder how strong the future is going to be.

In the developed markets, or the international equity rather on page 11, interestingly it's not that emerging markets on the far right is taking a break, but where previously it was the developed markets that were very much struggling, particularly places like Europe and again, the markets aren't the economy. The European economy is a wreck, their stock market was up 19.2% in dollar terms, they did better than the emerging markets. Only the Pacific X Japan did get higher returns than you saw in Europe and in the UK. Gerry Cruz: Pacific X Japan... Terry Dennison: Australia, Taiwan... Gerry Cruz: China... Terry Dennison: Not the emerging markets. Remember Australia is kind of a funny market, basically pretty soon it will be gone, it will just be a hole where it use to be because it's all just getting shipped to China, there will just be a hole in the ocean where Australia use to be.

On page 12 the emerging markets continue to be strong and this is something we've seen for a while. China isn't doing as well, if we think of the other BRICK countries, Brazil which is doing extraordinarily well, India and to a lesser degree Russia are significantly out performing China. China I think is beginning to get into a bit of a bubble stage, in fact the Government I think is beginning to be concerned about inflation, they're raising interest rates, they've actually strengthened their currency relative to the dollar a little bit to try to manage the economy, the party is getting a little out of hand there, but clearly

in the developed world most of all in Brazil which seems to be doing just about everything right, that's the place to be.

We have sector charts on page 13. Fixed income on page 14. This is the one area that's most immediately and directly impacted by Government action. The Federal Reserve with its quantitative easing 2 is trying to stimulate the economy by lowering interest rates in their target areas in the middle of the yield curve and this as we talked about earlier that's had actually a reverse effect because they've now actually engendered something we thought had been long gone which is the specter of inflation.

One of the interesting things which I think is positive for the future, if you look at the second sub bullet under the Barclays Aggregate Index, commercial mortgage backed securities had a strong quarter up 6.4%, highest return of any sector. Commercial mortgage backed securities were believed to be the next ground zero for trouble. After the tremendous issues we had with residential mortgage backed securities, commercial mortgage backed securities were thought to be the next big blow up. And, obviously it's not just happiness everywhere, you do see a lot of empty stores and shopping centers, you go to the mainland even at Christmas time, there's a lot of empty stores, a lot of shopping streets may have a third or quarter of their stores empty, but at least the commercial portion of the market which is more than retail, it's also multi-family which has done well as people have not been able to buy a house or basically had to give up the house they have and move to an apartment. Office, commercial, industrial, we're not seeing the crash and burn and CNBS we thought we were going to see after the mortgage backed securities.

The high yield index which is something that had a spectacular rebound, we were looking at returns above 50% coming out of the recession. As the market began to realize that half the companies in the country weren't going to go bankrupt, again had a strong quarter, part of this is improving economic conditions which means they're less likely going to default and also people are becoming less risk adverse, the risk trade is back on, people are feeling less concerned about what's going on in the market and willing to take risk to get higher returns.

Page 15 is a little bit technical. Mortgage backed securities, the way the pricing works is, to determine the value you have to consider the fact that a homeowner with a typical mortgage has a put option, they can refinance and pay back the existing mortgage and will do that if rates fall enough and thereby you get your principal back, but you lose the stream of future higher yields. So there has been changes to what's called the mortgage backed securities pre-payment model, because of significant increases in underwriting requirements where all the old paper work is back, the 20% down, more restrictive loan to value, much higher income tests, it's much harder to refinance. So even though rates are very low, now they've jacked up some because basically mortgage rates are generally keyed to 10 year Treasuries and that's been the area where we've seen

the pop, we may have seen the bottom of the mortgage rates. The people who can finance have and the people who would like to, can't. The number was amazing, if you go back to 1990, the 50% point was like 5 years, at the end of 5 years, half the mortgages have been paid, almost nobody kept their mortgage for the entire 30 years. Right now there's very little re-finance activity and what's happened is where previously their assumption was that the average mortgage would last 5 years, now it's been 6, 7, 8 years.

International Fixed Income... Gerry Cruz: Do they change their model often? Terry Dennison: They do but not quarterly, they do it when there's really a significant change. Gerry Cruz: Does this change the PSA's as well? Does it change in line, is there almost a direct correlation... Terry Dennison: I think there's probably a relation that they want to have, they don't want to have an anomaly, so they'll make conforming changes so you don't have a kink in curves, you want to have a smooth curve, you don't want to have an odd break.

Page 16 looking at International Fixed Income, again it's got a lot of intervention in the part of Governments. European Central Bank has been buying Government debt, largely to keep the banks from failing, without support, most of the banks in Europe would be bankrupt. They say, we're out to help the people, well they're helping the banks...and obviously we're now seeing the credit concerns move... I was in Portugal 2 weeks ago and they're probably next up in terms of needing to bail out. The big question of course is Spain because Spain is about 11% of the European Union Economy. Greece, Portugal and Ireland together aren't 6%, so that is kind of the big domino and now you see issues being raised by Italy, which while most of their debt is locally owned, they're highly indebted. Noises about Belgium and even France are seeing their interest rates rise a little bit.

There's a little bit here about Stable Value and this is of course something in your DC Plan. Stable Value across all 401k plans, not in your plan necessarily, saw large in-flows, people are going back to the Stable Value as an investment option. Realistically bond yields are so low, why not just lock up a little bit better rate. There are still some concerns with the Stable Value market what is called "wrap capacity," because remember how the Stable Value works. Wrap capacity is still tight, a lot of the players in the wrap business, companies like AIG obviously suffered poorly during the financial crisis and pretty much exited that market and like any scarce market, prices have risen and because the underlying bond returns are low because underneath the Stable Value Fund there's a bond portfolio, those yields are low and the wrap providers are now demanding a larger cut for basically assuming the risk in that bond portfolio. So what's happening is Stable Value yields are falling and that's a combination of the decline and interest rates as well as the reduction in the number of wrap providers. A few people have decided to exit the business, State Street Global Advisors has exited the business, it's no longer profitable or interesting for them and Bank of America, Merrill Lynch is also closing one of their funds.

I want to take you to page 26 and then to page 27. These have to do with, first moves by the FCC to deal with what is believed is profiteering on the part of managers charging excessive fees and excessive 12B1 fees, the distribution fees. The sense is and the Government is acutely aware as we spoke of earlier, that DC Plans are becoming the common retirement vehicle and that if people are going to have any significant wealth when they retire, they have to keep the fees they pay for the investment services and one of the things that people don't think about is they'll look at the fees, on a mutual fund perspective, 40 basis points, four tenths of a percent, \$40 on \$10,000 how much can that hurt and they forget that it's 40 basis points every year whether you make money or lose money. If you sort of extend out by just compounding that number, if you have \$10,000 and you put in \$1,000 a year, that \$40 per \$10,000 or 4 cents per \$100 begins to significantly erode the amount of wealth and the Government while still wanting to provide a relatively free market in mutual funds wants to deal with some of the most egregious of the fee abuses by increasing transparency, making the fees more clear including not just management fees, but other expenses and in some cases, capping these 12B1 fees, they're going to cap the fees at 25 basis points a year. I believe that in your plan all of your are below that which would be true for most institutional plans that are large, but there are a lot of smaller plans where in order to get the record keeping to work or to make everybody rich other than the participants, they are charging as much as 75 basis points, so the Government is trying to crack down on this.

On page 27 as part of the financial reforms, there was a belief of what are called "swaps" caused damage in the financial sector. A swap is where you agree to pay somebody else's return stream in exchange for them paying you a return stream. They're used a lot by defined benefit plans that are wanting to match their assets and liabilities. They're also used for speculator transactions and in Congress inimitable fashion, they said, these are evil, ban them all. The problem is that the way Stable Value funds works is there is in effect a swap embedded in the way Stable Value funds work, because in effect what the wrap provider is promising you is a stream of income at a calculated amount in exchange for taking the income from the bond portfolio, that's a swap. So the strict interpretation of the federal rule would basically make Stable Value funds impossible. There is, (surprise, surprise) a Stable Value association, it's a trade group of people who do Stable Value funds. So they have been lobbying the SEC about this interpretation of the Dodd-Frank Act, which is the financial reform act and they're probably going to limit it to swaps that aren't involved with Stable Value and absolutely will not consider swaps that exist today to be prohibited, but this is still an open area. You can see even from your fund which is about 12% invested in Stable Value, there's a lot of 401k plans that are even more concentrated in Stable Value. Eliminating Stable Value as an investment option is a collateral damage, I don't think that's what was intended, but that's the way Congress writes their bills. (That's it on the economy and the markets and I will be happy to answer any questions. We will do a quick run for you and I am going to cover the Metropolitan West issue.)  
(End of discussion for Economic & Capital Market Environment)

## Defined Benefit Plan

### 10:00am-10:45am DB Plan – Quarterly Performance

Under tab 1 let's take a look at, there's some developments noted on page 29, a change at DFA which we don't think is any particular import, because their process is largely mechanical. The big deal is on page 30. One of your equity funds is the Metropolitan West Large Cap Intrinsic Value, it's actually managed by a subsidiary of Wells Capital and it is the predominant asset, about 90% of the firm's assets are invested in this single product. The key guy, his name is Howard Gleicher and one of his colleagues, Steve Barosky left, they left to join a firm, actually to establish a firm called Aristotle. They basically founded this company which was sold to Wells Capital and before that they ran money for a family foundation and they probably didn't feel it was much fun anymore to work for Wells Capital which is part of Wells Fargo. I spent 12 years working for a big bank and if you're a real entrepreneurial kind of do your own thing, big banks don't work for you, so they left. You can read the notes here, our summary is and I think it's a stronger view than what you got from somebody else. While we put in here monitor, because and again to remind you, I don't want to say, get rid of these guys because if for whatever reason you choose not to and I'll show you a reason why you may not want to, at least not at this second. I've put you in a bad fiduciary place, but on the record, our recommendation is leave. These guys are the decision makers, these 2 guys. They're gone and obviously and we see this with managers all the time and as I've said repeatedly, consultants have a cynic gene, we're very cynical people because we get told all sorts of really interesting stories. Before these guys left, these are the thinkers, these are the brains, these are the people doing everything, after they left, they just made sandwiches for the other people, they carried coats, signed lunch checks, they're of course going to find somebody replace them, but these guys were the product.

Let just show you, these are not a group of people who are doing badly, turn to page 34. I think I commented when I was here 3 months ago, these guys and this all happened in November, these guys are creepy good, they are basically doing what I would cynically say is impossible, which is do well all the time. They are at the very bottom, if you look at... and the last 3 months, remember this is through 9/30 and this move took place November, December, but if you look at for year to date, one year, 3 years, 5 years, they're better than the top decile. I don't remember the word for what the top 5% is, but these guys are better than 95% of the managers out there across the board not just in terms of the relative ranking, but look at how much better they did in any market environment you want to pick. If you look at them for 5 years, they were up 5.6 in the second percentile when the market was or when the median manager was down 50 basis points and was in the 78<sup>th</sup> percentile. For 3 years, generally cruddy market, they were down 2.4, the median fund was down 7.4, the market was down 9.4, 5<sup>th</sup> percentile. Surging market, year to date they were up 10.1,

first percentile, the best. They beat the market by 3 times, they beat the median manager by 2 times. You can make an argument, why don't we see what happens they've been so good, don't because these guys who made these numbers aren't there anymore. Gerry Cruz: So these 2 guys are opening their own firm? Terry Dennison: Kind of, Aristotle may have existed previously as an entity, it is connected with this family. My guess is and this is the concern you will see expressed in here, you're going to see the famous zipper effect, they have friends and they're all going to go too. So basically what I'm suggesting you do, simply because our belief is these guys were the product, is to get rid of a manager who is in the top 5% and who has added value, huge value across every single market environment, but this process is broken. This is not a watch, this is not a monitor, we use monitor simply to give you that freedom. My recommendation is out, these people are gone, the thing is on automatic pilot. Again, this is something you can index, stick it in an index fund, yes it's a place where we think active management might be able to add value, but because of the way we have the plan structured right now, we could index this. These guys made you enormous amounts of money. You ought to do an RFP, but we will park it in an index fund just like... that's why (Mr. Chairman) we went to the Legislature and said, can we have the latitude to an index fund, a parking lot. Gerry Cruz: Was this a surprise? Terry Dennison: Yes. Doris Flores- Brooks: Was there word on the street ahead of time or they just up and left? Terry Dennison: They just up and left and I don't think this firm will survive, this is 90% of the assets. Gerry Cruz: Right, this is huge, I knew this was huge. Wilfred Leon Guerrero: Make this a recommendation... okay, Gerry (Cruz) and Bill (Aflague), do you agree to Terry's (Dennison) recommendation? Gerry Cruz: Yes I do, I agree. I was wondering what your recommendation was going to be. Wilfred Leon Guerrero: Give me the rationale for this, it's changing the CEO... Terry Dennison: It's changing the decision makers who are principally responsible for or perhaps exclusively responsible for the results you have, have left and we have no visibility and no confidence in where these guys are going. Wilfred Leon Guerrero: And you're recommending that we put it in an index fund? Terry Dennison: An index fund, yes. Now you might go to Aristotle. Wilfred Leon Guerrero: I don't know whether we can do that. Terry Dennison: You can't do it now, but you could... Wilfred Leon Guerrero: We're going to have to put an RFP out. Terry Dennison: Now one of the things here and I refer to staff here, Rosie (Bordallo) and Diana (Bernardo), do we have enough in the ETF bucket to pick up these guys too, because the ETF bucket is of some size. Rosalie Bordallo: We have enough. Wilfred Leon Guerrero: Alright, that's one recommendation that we're going to make at the Board meeting.

Terry Dennison: Let's go to page 34, I'm going to skip some of the summary performance data. I want you to look at the total Fund performance on page 34; for the quarter, you're in the 11<sup>th</sup> percentile, fiscal year to date the 14<sup>th</sup>, one year 14, 3 years 10, 5 years 11. You are generally amongst the top 10 performing funds in our data base, you guys did good. I've been in this business for nearly 40 years and I go back to when crystal balls were in black

and white, now they're in color, they still don't work very well. But, the question is an interesting one, why were we so good? And the principle, the drivers of managers like Metropolitan West certainly helped, but its asset allocation. If you think what the asset allocation looked like 6 or 7 years ago compared to the asset allocation now, not only are you making more, but your volatility is less, you're not exposed to a small number of asset classes. Doris Flores-Brooks: But of that you said Metropolitan West did an outstanding job. Terry Dennison: They certainly helped, but if you look at the one year return, we're up 12.3% and the blended index is up 9.6%, which means our managers contributed nearly 3%. Our managers contributed 2.7%, which is huge on top of the performance of a good asset allocation. Gerry Cruz: It's the roll of the dice on the managers I think. You may get a good manager, but... Terry Dennison: They go up, they go down and they change. Not just that you've done well in a period, but you've done well across, just think of the market environments that you've done well in, that 5 year period was the last of the really spectacular markets we had fed by excessive debt and excessive financial foolishness. The worst market since the great depression and a modest rebound throughout that period and for every period within that period you have been approximately 10% of pension funds.

Looking at some of the managers and again, the managers, I always have to remind people that you expect and in fact you actually want a small number of managers to be performing badly. Here's the reason, the market goes through cycles where particular sorts of stocks or particular sorts of strategies do well, but what you want to have is, you want to have a diversity of styles. If you had all of your managers thinking the same way and that's whether or not they're in growth or value or in large or in small, but they all thought the same way in those periods whatever the way they thought was in perfect tune with the market, your results would be spectacularly good, but styles change, cycles change, you then have everybody doing badly. So the central bargain again with diversification in exchange for giving up the circumstance and everybody is doing badly, you forgo the likelihood that everybody is doing good. If you find managers that are doing badly regardless of the cycle, maybe we have to question them.

If we look at Atalanta, their performance for 3 years and 5 years is really excellent. In the 3 year return 20<sup>th</sup> percentile, they saved us 290 basis points by falling less, but as the market has rebounded, their performance has not kept up. On a ranking basis, they're down in the 10<sup>th</sup> decile, the bottom of the heap. For the fiscal year to date their return was exactly half the markets return. So here's a manager who outperforms when the market is going down, they lose less money when the market is going down in exchange, they make less money when the market is going up.

Winslow is relatively new, but their performance has been improving. For the quarter they were 10<sup>th</sup> percentile, 220 basis points, 2.2% ahead of the benchmark.

Intech which had a tough start, their performance and what you do have is a break here, because if they don't have 2 and 3 quarters performance, we don't see them, so their performance if we showed them for 3 years would not look good, but they have improved. They slipped a bit for the quarter but now they've improved dramatically from where they were. Gerry Cruz: Did they make any changes to their model, because they're pure quantitative? Terry Dennison: They're pure quantitative, they're always tweaking the factors otherwise they'd become un-commercial at some point. They have to continue to recognize that the markets evolving. Gerry Cruz: Are they growing their business? Terry Dennison: It's probably flat because a lot of people became disenchanted. They were doing so well, they seem to do magic for a while and there are people who chase magic and when the magic stops they go looking for someone else whose magic is magical. That's not a good investment strategy, but there are people who do that.

Robeco is slipping. On a relative basis they've gone from the bottom of the 3<sup>rd</sup> quartile to the 4<sup>th</sup> quartile, pretty much negative alpha or value added, you'd be better off with an index fund versus Robeco.

Obviously we have talked about Metropolitan West. If they hadn't had the people leave we would look at that quarter where they fell out of the 1<sup>st</sup> percentile, certainly the 1<sup>st</sup> decile and say, that's nothing, but obviously because of it and I don't really think they fell from the 1<sup>st</sup> decile down to the middle of the 2<sup>nd</sup> quartile because of what happened, I think it was just timing.

(I'm only doing the active managers so things like ETFs I'm not even going to talk about because they just track.)

Fisher which has been up and down and all over the place is on an upswing certainly on a relative basis. The year to date is negative, for the quarter they were 16<sup>th</sup> and significantly ahead of the benchmark.

Dimensional which is the International Small Cap is pretty much median, pretty much index across the board. It has added value in the middle parts of the period, if you look at them for year to date, significantly ahead of what you would have gotten with an index fund so they're fine.

Cap Guardian there's a discussion here and there's a similar discussion in the DC report. Cap Guardian is a huge money manager, not just in terms of staff on scale, but in the amount of assets they manage.

You will hear consultants talk in a very derogatory fashion about a manager being an asset gather. Obviously managers, revenue and profits and ability to pay their people is dependant on their assets and their management as well as obviously their fees. You have to have managers who are successful enough to



pay their people, keep their people, have all the resources they need to be successful, but size ultimately becomes a negative for you.

My day job really is involved with research at Mercer and one of the research projects that we're working on is really to try to critically assess when you should be active and when you should be passive. We've developed a paradigm, a way of thinking about that question that looks at 3 factors. The first is what is the inherent in a particular segment of the market like Large Cap Growth, what is the inherent opportunity to add value if all the stocks are fairly priced, if the market knows what things are worth and prices them, there's no opportunity to add value. Those kinds of markets are called efficient. Everything that's known or knowable is in the price. That's not a good candidate for active manager. But, if it's a market where things are not well priced, there can be a significant opportunity to add value, but then there are 2 negative factors. The first one is the behavior of managers. There's some interesting research that's come out of academia that demonstrates that active managers best ideas work. If you could invest in managers best ideas, you'd make a lot of money. They're really actually good at spotting 10 or 20 or 30 stocks that aren't under valued and they do pay off and they do produce big returns. But if you think about it from the manager's perspective, you can explain all sorts of crazy things just by putting yourself in the shoes of the manager. If you think about it from the manager's perspective, that limits their ability to make money, because if they have 20 good ideas and the most they could invest in those 20 ideas is say \$2 billion, that's the most money they can manage. Well, maybe they don't want to live on \$2 billion worth of fees, maybe they want to live on \$100 billion worth of fees. So rather than having your interests at heart, surprise, surprise, they have their interest at heart. What they do is they say, we will let the product get bigger, we will have a product that has the best ideas but then because there's not enough money we can put in those best ideas, we'll put in some pretty good ideas or we'll put in stocks that are big in the index so we don't look so different in the index and that kind of behavior is called asset gathering. Basically we're going to grow our assets under managements called AUM, we'll grow our AUM arbitrarily big even though the value to our clients of our best ideas is so diluted that there's no real value left. Now responsible managers (and that's a value judgment and I'll own up to that) responsible managers say, we're going to cap the product. Sometimes you'll see in our notes, particularly in the big book discussions about we're going to cap product. In fact one of the funds that is in the DC Plan, Champlain, they have capped the product, they're allowing money to come in from DC which is sort of through the back door. On the DB side they won't take any more money because they said the fund is as big as it can get or almost as big as it can get and still get the benefit of our best ideas. That's responsible behavior, now basically what that's saying is, we're going to forewear making even more money to benefit you guys.

Cap Guardian has a different view, Cap Guardian says, we're just going to grow the business as big as we can make it and get as rich as possible and if you

don't make any money, well that's too bad. You can go back 3 or 5 years of these books which are around here some place and see concerns being expressed from Mercer about the fact that Cap Guardian Research and Management, which is the technical name of the company is not acting in the interest of its clients by allowing its funds to just grow enormously large and thereby really reduced to almost negligible the possibility of any value added. Joe T. San Agustin: Why are we hanging onto them? Terry Dennison: Historically they've done ok, but the problem is at this point...well remember it's easy to say, off with their heads, but then you have to go find somebody else. As long as they keep winning, we'll hold our nose, but what we're saying here is and there's something going on there and it's written up in the book, they have now recognized that having a 200 person investment team is too big. So, their solution is to divide the 200 person team into 2 100 person teams and that will fix the problem (and if you think that's true, we have a bridge you can buy).

The reality is if you look at their performance, they've done ok and remember we were for no fault of anybody, but we were a little late getting emerging markets because the structure of the Capital Guardian fund was a little unusual. It's combined with a 3<sup>rd</sup> party custodian and this caused some plumbing problems. I have to tell you what I believe and I hope it doesn't sound like, Terry's leaving so burn the place down, but I think at this point they're not doing badly and it hasn't up, I mean it's not like everyone is leaving, but at some point this is going beyond putting lipstick on a pig. You read this and I know people that rate these and in fact the woman that wrote this has sometimes an extravagant use of the language that I have to push back on, her name is --- and she must have been laughing her head off as she was writing these words, because we went to their annual conference and this just sounds, let's just take these 200 people and we'll divide them into 2 groups and that will make everybody wealth, like really. So, at this point it's not like we're getting rid of somebody that's good but you might put out an RFP. Remember you can put out an RFP without committing yourself to make a change. I think frankly it would be good to do a market check and see what else is out there because we hired these guys 4 years ago. It might be worth while to do a market check, but this behavior we have got the same issue with one of the stock funds in the DC Plan with the same issue, it's the same organizational structure. It's actually worse than the DB Plan because that fund is truly gigantic and nobody can produce enough good ideas to significantly add value to a fund that large.

Now we're up to number 2, this is a market check, let's see what else is out there. I think Metropolitan West, they have to go. I think in both for the DC Plan and the DB Plan I think given how that recommendation or how the language describing our view has become stronger and more strident and if you read the words, it's getting even derisive in terms of how we characterize our view of this supposed solution to the thing that's too big.

I think you should do a market check on these guys both in the DB Plan and DC Plan. Obviously for the DC Plan that's just a search, that's not an RFP, but

I think at this the likelihood that they're going to produce satisfactory results or satisfactory plus results for your participants is just getting too low. This is the American Funds and Cap Funds.

It's interesting if you turn to page 62 as long as we're talking about Cap Guardian, this is looking at the performance for American Fund, it's the 3<sup>rd</sup> from the top and you can see that the performance has been declining both on a relative basis and an absolute basis. This is Cap Guardian, Capital Research and Management, American Funds are their DC brand. And again, this is not a get out now today if you can, tomorrow if you can't get out today situation as we had with MetWest, but on a long term basis these guys are just not, their behavior is such as they're not making themselves rich. If you look at them for the trailing 5 year period, this use to be a good fund. Gerry Cruz: They just got too big. Terry Dennison: They got too big, they got greedy. They put themselves in front of you, their interest in front of your interest.

So there would be an RFP on the DB side and a search on the DC side. Gerry Cruz: Okay, that's an action item.

Terry Dennison: Going to page 36 on the Fixed Income side, Income Research and Management and Davis Hamilton Jackson have done very well, positive alpha. IRM looks weak relative to other managers, but their style is different because it's more corporate oriented, but look at the value added versus the benchmark, you did a lot better with these guys than you would have with an index fund. Gerry Cruz: Do we know how much is still in that transitional portfolio, in their transitional portfolio? They should be close to liquidating. Terry Dennison: The market's been pretty good and anything that's been cruddy is really cruddy.

Franklin Templeton is also not doing particularly well. The thing that's an issue here is obviously Fixed Income is 30% of your portfolio and you've got 3 managers and each one of these managers is 10% of your assets. I'm not suggesting that we increase the core of Fixed Income managers, but each one of these guys has got 10% of the total fund. Franklin Templeton their performance is actually worse on a relative basis, really down in the bottom decile. On a basis relative to the benchmark it's not terrible, but that's certainly something that's certainly bears watching.

The Fixed Income is tricky because your guidelines are such that your managers are restricted and other managers are playing a different game. So it's easy to say, their in the bottom 10%, let's get rid of them, but you can see even good managers like IRM and Davis Hamilton who are adding a lot of value relative to the benchmark are struggling versus other Fixed Income managers and part of that is your guidelines. Gerry Cruz: Did that new law change, I know it passed, but that just talked about agencies. Terry Dennison: This is interest coverage and ratings. Joe T. San Agustin: The Bill was just signed the other day. Terry Dennison: That was the mortgage backed, the pass thrus.

We're talking the screens, so it's easy to say, these guys 96 percentile, how can we keep them. Well remember other people are playing a different game, they're buying non-investment grade bonds, remember how good yield bonds were doing, junk bonds had a tremendous recovery. These other managers aren't playing the same game you are, so before we say let's go out and find somebody else, these guys are now good, let's reflect it in a sense we are making these guys not so good. We are limiting their options at an adverse time. Now having said that, there were clearly times when our guidelines saved our ---, seriously because people who were fishing in the swampy part of the pond going into the steep decline lost tons of money. This is the other side of the teeter totter, we protected ourselves on the downside by having more rigorous guidelines, well when the market turns around there's no free lunch, we're going to pay. So, we're not recommending you do anything to any of these guys.

Gerry Cruz: We know that going in that we're limited on the upside, but we're protected on the downside. Terry Dennison: You would have made more going into the market because it was low quality junk that did well, you would have given it all up and then some. So long term you guys are doing okay with Fixed Income. Gerry Cruz: Is there anything we need to do just knowing the Fixed Income market in general is... these are all active duration. Terry Dennison: They're all active duration or within the guidelines, also active sector and security. Gerry Cruz: That's the best that we can do? Terry Dennison: It's the best that you can do. You could divide it into, get another manager that's somewhat different in some way and just slice the pie into 4 pieces instead of 3 and that's just reacting to the fact that each of them has 10% of the total Fund. If somebody gets it really wrong, it's going to bite you because these managers are all big. Gerry Cruz: Would it be prudent to discuss maybe reducing the allocation and moving it to something that, or maybe an alternative like REITs? Terry Dennison: Well, the REITs we have almost 12% exposure to REITs, in fact it's pushing out the top. It's done so well it's actually pushing out the top. We've got an asset allocation chart in here, if you go to page 38, the right hand panel, second from the right, Real Estate, the little t-bar is the maximum and the minimum. You're at the maximum. These guys have gone from 10% to 12% despite the fact everything else has done great, these guys have done greater yet. So I think and again I don't have a perfect recollection, but I think you have some statutory requirements about the minimum amount of fixed income or conversely the maximum amount of non-fixed income you can have and I think what we did is we considered because of it's inherent characteristics, we considered Real Estate to be fixed income. I don't think we have a lot of latitude here.

On the Real Estate side the managers have been behaving as we would expect them to. Security Capital more risky is doing terrific for the longer periods. Cornerstone the more conservative is actually doing very well also and you've got to be drawn just to the numbers in the 30s. That's by far your best performing asset class. Well, not compared to emerging markets, but even though emerging markets have tailed off some, because of the slow downs, right

now the numbers we're reporting here, these are the best performing asset class for the last year.

A couple of things of page 38, Small Cap is near the minimum. Right now as we saw as we looked at the market environment, there's no real difference between the performance of large and small, but historically Small Cap has been a little bit better returner than Large Cap, so that's something worth thinking about. Developed markets is really at the ceiling again. International has done really well relative to Domestic and Fixed Income so that's due to market effect. International Small Cap is actually at the floor. Emerging Markets is right in the middle. Fixed Income, now part of that is the fact that we in effect took Real Estate allocation out of Fixed Income but didn't adjust the maximum of Fixed Income. That's why you look like you're almost under weighted in Fixed Income but you're really not.

Page 39 this is another one you should hang on the wall, this is attribution, this is why you're doing so well. This is breaking your performance into 2 pieces, asset allocation and manager effect. The green is asset allocation, so across the board with the exception of equity, asset allocation has been very helpful. The gray is manager effect and pretty much across the board the managers have done spectacularly well also on top of the spectacularly good performance from the asset allocation. So, if you look at the total Fund, you've got fantastic asset allocation performance and fantastic manager performance and that's why you're one of the top 10%.

Finally, are we taking excessive risk to look this good. If you look on page 40 what we're looking at is the little green dots are different funds and basically what we're mapping the funds on 2 dimensions, vertical dimension is return, the horizontal is standard deviation of volatility. What you see is a cloud, but you can generally draw a line through the cloud and the line is typically upward sloping, the more risk you take, the more return you get. And what you want to be is you don't want to be taking risk and not getting paid for it. If you look at the blended index which is the dot, the center of the gray bars, the gray bars represent the one standard deviation confidence interval, that's where two thirds of the distribution lies. The red box is where you are and basically you're getting paid for the risk you're taking. You are a little bit more risky than the blended index, but you are getting paid for it.

(End of discussion for DB Plan Quarterly Performance)

### **Defined Contribution Plan**

#### **11:00am-11:45am DC Plan – Quarterly Performance**

Terry Dennison: There's a discussion on page 46 which I'm only going to reference in passing because Champlain has closed the fund other than contributions from their mutual fund. So they are acting responsibly as opposed to our friends at Cap Guardian which are not.

There's a lengthy discussion in here on page 48 on Cap Guardian and if you read the words, the words are the strongest I've seen in terms of our concern about this, but we've dealt with that.

Pages 51, 52, 53, 54, 55 and 56 are looking at asset allocation. With the plans combined on 52 and 53 and just the 401a on 53 and 54 and the 457 on 55 and 56. Interestingly if you look just at the distribution the table of the center bottom, look at it on page 51, which is the plans combined and then look at 53 and then look at 55. If you hold the book like I'm holding mine, you'll see that the combined is an average of 2 very, very different asset allocations and that is explainable because of the nature of these funds. Page 53 is the 401a, which is the required plan that everybody has to have and that asset mix is 70% Lifecycle, again that was transferred from... a lot of funds were mapped into that. I would say that and I've made this statement before, the Lifecycle Fund is really the most appropriate investment for the vast majority of people who really don't understand and don't take the time. So, 70% is frankly where we'd like to see funds get, you got there through the back door. Now look at the 457 which is the voluntary plan. People who make voluntary contributions are typically your more highly compensated employees, they have money to do it. The low compensated people have enough money to eat, maybe. So these are people who probably have other assets and are probably more sophisticated. But, look at the difference between page 53 and 55 that the 457 folk have got one third of the money in domestic equity, almost 50% of the money total in equity versus a little bit more than 21%, almost 22% of the 401a people. So, if you just looked at page 51, you would say, okay that looks reasonable. If you looked at the 2 individual plans and the constituents in the 2 individual plans, they don't even look like they're the same population, which of course they aren't one is the subset of the other. The 401a people who are behaving like a broad relatively low paid, unsophisticated population and the population on page 55, the people who are contributing voluntarily in the 457 Plan, they have a much more, almost DB oriented asset allocation and I just saw that interesting.

On page 57 we have the Fund line up with the recommendations, again we put here American Funds monitor, it would make it strong, it wouldn't be terminated and replaced, but I think doing a search and seeing what's out there would be healthy. For no other reason, I think it would look good. We want to act well, but looking good isn't bad either.

If we look at the performance and let's go right to the summary on page 60. Generally the funds are doing pretty well. There's an interesting factor if you look at Fixed Income, it's not anything regarding the funds per se, it's just an interesting number. If you look at the performance of the Tips Fund, the BlackRock inflation protected bond, the performance of the Tips Fund which is like an insurance policy, now inflation is very low right now, so this also will adjust for inflation, but even though inflation is low, its outperforming in

absolute terms, the Hartford total return bond fund. So the people who are invested in Tips are not only getting inflation protection, which they will eventually need, they're actually getting a higher return than people who are invested in the bond fund that doesn't really have any inflation protection. So because it's relatively new, there's only a small amount, 312,000 in this, but the reality is what you have is that you are in effect getting the insurance coverage against an inflationary run up for less than nothing. It's like an insurance policy where the premium is less than nothing.

The International Fixed, obviously as we saw with the economic discussion, the international market, particularly in Europe is now totally dominated by the activity of central banks and fiscal and monetary authorities. The performance was not good on a relative basis, 98 percentile, but for longer periods it's been excellent and even during this bad period, the performance relative to the index has been good.

Dodge and Cox we're getting rid of as the fund is really redundant. The Lifecycle Funds, generally the performance has been okay and it does make sense in the sense that the nearer term are producing lower returns than the farer terms, because they're more dominated by equities.

The Windsor 2 fund has got roughly median performance, lagging a little bit, but nothing worth action.

We talked about the American Funds; again I think it would be good to do a search simply to figure out whether or not there are better options out there.

The Franklin Small Cap continues to do very well both on a relative and absolute basis. Pretty much as does Barron and Champlain, again it's closed, it's median plus, nobody would have any significant complaints about those.

The Thornburg fund which has been generally a good performer definitely got wrong footed this quarter. (We're on page 63) Where it's been in the first quartile all along and has produced excellent results relative to the benchmark, this quarter it only lagged the benchmark by 200 basis points, but it's doing much better and Pioneer is being replaced by DFA.

On page 64 on the fees, the only one that's problematic that's been addressed, is Pioneer and we're replacing them with DFA. People are paying a lot of money for bad performance with them.

There's one page on 65 which is a summary of our issues regarding the American Fund.

(End of discussion for DC Plan Quarterly Performance)

## 1:00pm-1:45pm Security Capital Research & Management - REITs

...Office and retail in the United States and if you look at office and retail in the United States, I'm going to make you turn back to page 19. On page 19, other than multi-families of large part of your portfolio, the next biggest part of your portfolio is office, that's far to the left. In the office markets in the United States we've really focused you on 3 office markets and they are mid town Manhattan, Washington DC and western part of Los Angeles. Those are the only 3 markets that we think really have demand generators that will give us some sense of the big plunge in occupancy and rents that have occurred due to the recession. That's where you're going to see growth first because the economy is starting to move in those markets. Basically New York has surprised everyone on the upside how fast it healed, how fast they hired back and there's nothing being built in any of these markets other than a little bit in Washington DC. Demands come back fast and so rents are already starting to come back up and you own a lot of mid town Manhattan office in the companies that we've invested in. We also own a lot of Washington DC. Washington DC never got weak because of all the tax payers in the room here, paying your taxes meant there are more people being hired in Washington, the Government is growing bigger not smaller and that's kept the office occupancy rates very high. In fact, the highest price in the United States for office space on a sales basis is Washington DC where they are regularly getting 6-700 dollars a square foot when they sell office buildings. Remember because of the Capital, you can't build higher than the Capital so there's a limit to the supply of office space in the District and it's become very dear and that's where we focused in our ownership for you.

Finally West Los Angeles, West LA we like a lot, it's a market that is entertainment centric, it's where the rich people live in Beverly Hills and they like to be close to their offices, so it got weak in the recession, but it's come back very fast because the people are still rich in Beverly Hills and so we like that market.

Every other office market is poor in the United States, very poor and we're trying to be very careful not investing in companies that own for example an office building in Nashville, Tennessee or what we'd call a secondary --- market, there's just no demand until employment comes back. Those markets are very weak, they will slowly get better but it's a very, very slow improvement. So with office we're very selective and that doesn't hurt you, it's helped you a little bit, but we really haven't seen much growth in office rents until we get employment going.

The other most important part is retail and here the story has been very different. Depending on what kind of shopping center you own, some of the shopping centers in the United States are doing extremely well and those are shopping centers and here the shopping centers which would be a grocery store on one end and a drug store on the other end and what we would call strip in



the middle, small little retail stores. That's one type of shopping center and then there are the big regional malls, the very enclosed centers that would have big department stores on each end. If you own a regional mall that caters to affluent Americans, the very wealthy, those malls have done extremely well this year, they bounce back very, very strongly. Why, because a lot of rich people stopped spending because they were afraid when the economy went down so fast, but they were still rich again and so they started spending again. So the retail centers that catered to and you own a lot of a company called --- and Simon and ---, these are mall companies that own the highest quality malls in America, they've bounced back and they're very, very strong, The other side is very weak. If you own a shopping center that caters to mid America or to the non-affluent, the lower income, those are struggling, that's where the employment losses are, that's where it's very hard to get a job and if you own that type of shopping center, it's been very weak. Now our job to you is not to make a social comment on what should be doing well and what shouldn't, we just have to do our research and say, where are we going to get the cash flow for all of your investors, for all of your people in your fund. Our best judgment is the affluent are going to support much higher sales growth, that's where you want to own shopping centers. So we have focused you on the affluent side of shopping centers in American and that's worked very well.

What we're waiting for as we go through all the property types however, is job growth in America. We have tried to isolate you where we can, into markets that have unusual good demand, but in general we can't isolate you totally because we're going to own stock in 25 different companies, they're going to own 10,000 properties, maybe 12,000 properties in the United States and the biggest problem that is still our problem is no job growth. Until we get job growth, cash flow is going to be very, very slow to improve in every place other than apartments where you have real demand growing. So I'd like to kind of focus on those 2 concepts, where we're going to get cash flow growing and a different concept that really will answer how you made so much money this year. Cash flow is good, but why in general did REITs go up so much this year and that will be something else, that will be interest rates and debt. Before I do that I'd like to stop for a second, any questions you have on your portfolio, types of properties, extra risks... Wilfred Leon Guerrero: You're showing 5.2% non-U.S., where is that? Security Capital: That's in companies that are primarily domicile to the United States, but they own other things outside of the United States. So it's little bits and pieces of companies, but there's no one company that invests solely outside the United States. If we look at the companies for example, you own Prologis 6.15 and AMB, look at AMB property industrial, AMB is a large warehouse company, they own big warehouse, but the focus their warehouses around airports, the highest priced industrial in the United States and ports. The also own in Japan, they own in China and they own in Brazil. So what they've done is for U.S. companies that want logistics to move their goods around the world, they are primarily a U.S. based company, but if their clients want them to build a warehouse in Brazil, they'll build a

warehouse in Brazil also. They're mainly about 80% in the United States, but 20% of their assets are outside the United States.

Wilfred Leon Guerrero: Do you know of a company that's interested in investing here on Guam? Security Capital: Well, I'd have to think about that. Most of our companies would be led here by their clients; they'd have a company that's working here that needs them to build something here. So they react to client demand and so I guess clearly the companies that you invest in here, the most likely because of your tourism trade would be one of hotel companies... Wilfred Leon Guerrero: Some of us get elected to this Board and we have to explain why we're not investing here on Guam and I think the expectations is there's going to be a parade because of this military buildup and I don't know, are there companies interested in investing here? These companies are well established companies and I guess you just go look at their holdings and you decide, West Los Angeles is a good place to invest in, but if you have a location that don't have companies that are listed on your universe, how do you go about searching for those companies? Security Capital: Well, the first thing, because all we do is buy publicly traded companies that own real estate, so the first thing we have to look at is what do they all own and if they don't own something, there's nothing we can do about that. Wilfred Leon Guerrero: It has to be publicly owned? Security Capital: It has to be publicly owned and these companies have gotten very big, so one of the things they look for is scale before they go some place because they want to really actively manage their properties, they really need scale, they need to own lots of buildings in one place. Our companies, one are that they do own outside of the mainland is Hawaii, for example. You own a company that you can't see, it's not in your top 10, it's called CWH where they own most of the industrial property in Honolulu and they wouldn't own just one or 2 industrial buildings, it wouldn't go to Honolulu because they're located in Boston and to manage it effectively they need a really large critical mass to do that.

The only thing I can think of in terms of Guam certainly there's that economic activity and it could be accelerating, but there could be a big question in the minds of these companies that are \$15 billion to \$40 billion in size, would there be enough activity here for them to invest in that they could actively manage from the mainland that they would feel comfortable that they have control in. So they would need a lot of stuff before they can go outside of the mainland, I think. That might be one of the reasons you don't see them in Guam in terms of they own, for example, the apartment companies, they would want to own 3,000 apartments or 4,000 apartments before they would go some place new and they would all have to be institutional quality. Wilfred Leon Guerrero: How about the military, don't they rent facilities for their industrial use? Security Capital: I have to tell you I'm not familiar enough, what kind of investments are available in the universe, but I know right now I don't think any of them have assets in Guam. I guess the one thing I would think of is how much is for sale in Guam right now in terms of commercial real estate. Do you have any idea? Wilfred Leon Guerrero: I don't know but my sense is they're going to have to

build facilities. Security Capital: And a lot of these companies do develop, but it would have to be a really big scale. There's one company that builds a lot around bases and that's called which is called Corporate Office and that is one of the companies which you own in your portfolio. What they like to do is go in wherever the military is, they like to buy around it and provide facilities for the military, so let me think about that whether it's talked about, see if they ever thought about Guam. Otherwise there's nothing in the universe that we could invest in publicly that has investments here.

Rosalie Bordallo: Can I just ask one question? We're here on Guam and we continuously here about this military buildup that's to occur in the next several years and supposedly it's this huge military buildup. In the states, what is it they hear back there about this occurrence? That could be a factor if they don't hear anything, then they don't see an opportunity because they don't know about it. Security Capital: I think again the opportunity would have to be in the form of, we're going to build a lot of market rate apartment buildings, do you want to participate in that. So it would have to be that type of, they would have to actually be approached, here's an opportunity to either build on a large scale. So the question is, I don't know how open the commercial real estate market is in Guam in terms of, there's a lot for sale, there's a lot of... and here's a question, institutional quality, these would be very high quality office buildings, like your retail is too small for example for these companies, the retail is very small. Wilfred Leon Guerrero: What I'm seeing is I think Korean firms are the ones that are investing here. Security Capital: In the same sense you don't see a lot of U.S. tourists because of the distance. I think that distance because of the fact that it's really hard to get here is one of those issues that keeps the information flow slow. Right now and it is always important I understand you get elected and people want to know what about local. Wilfred Leon Guerrero: I'm just trying to explain my question. Security Capital: I understand that and we get this a lot like we invest money in a lot of state pension funds and a lot of times people say, what do you own in our state and we'll go through what we own, but the real question is, your participants want diversification so if something bad happens in Guam, their money is invested widely and so we've seen in commercial real estate the flip is a bad thing, where sometimes local funds will build buildings and stuff and that doesn't work so well. I think at the end of the day and as you all know is to get the returns that you're best satisfied with. What we have found, here's the most important thing to think about in commercial real estate, you want to own commercial real estate where it's very difficult to build new, it's very expensive to build new and so if you own at the right price, you're going to be good even in a bad market, your properties will hold up better, in a good market you'll get higher rents. So we're very picky about the kind of commercial real estate in a sense we want a big diverse vibrant economy in a very difficult build situation. That combination over the long term is what gives you the best rates of return so we always try to find real estate that we think will be shortage because that's how you get the rent increases.

Joe T. San Agustin: How active are you guys on healthcare? Security Capital: That's a great question. We like healthcare a lot. Healthcare in the United States, everyone knows everyone is getting older and the population is aging and so that's a demand generator right there and people are living longer and that's a demand generator. You have to be very careful about that story because about 10 years ago that story, every developer in America figured out that story and every developer in America built and built and built and then everything tanked because the key item is how many 80 year olds or 80 or plus, 85, 90 year old people and there were people who were ahead of the demand so they built too much in terms of healthcare facilities. That's not true today, the healthcare boom in demand is just starting, but there is very little new facilities being built in the United States. You have a larger weight today in healthcare than what's even on this page. The companies in the REIT world, companies I can invest in, they've changed what they own dramatically over the last 10 years, 10 years ago they owned nursing homes and nursing homes are in great demand and it's hard to build a nursing home, you would have to get a certificate of need, you just can't build a nursing home. The problem is that most of the people that are in nursing homes are Medicaid and require the Government to pay the bill and the Government keeps squeezing and squeezing and squeezing.

Our REITs what you own, they lease to operators of the nursing homes and the operators would go bankrupt and then they'd have a nursing home and have to find another operator and the market didn't like that, it was a very uncertain thing. The REITs that we own have gotten generally out of --- what's called skilled nursing homes and they've gotten very active in assisted living in medical office, in all of the other areas that are private pay because that's where they can get higher rents and that's also where there's not been a lot of building. These stocks took a hit during the Obama healthcare plan being passed because people were concerned that healthcare receipts from the Government would be harder to get because a lot of it's paid by the states and the states were going to get squeezed. Because you own private pay we kind of went, well that's an opportunity so we've been buying more healthcare, not less healthcare. Right now the healthcare stocks which didn't do great over the last 12 months, they did okay but they're considered defensive. When people were looking at better rents they didn't look at healthcare. All of a sudden healthcare stocks are starting to do very, very well, in fact one of your biggest holdings properties last night announced a \$6 billion dollar acquisition, so that's the kind of scale that they like to do, where they bought a huge portfolio, private pay facilities and the market which normally when they do a big deal, they say they're going to raise a lot more stock, the stock goes down because they're going to raise a lot more equity, the stock went up 4% today. The market really liked the transaction and so this is a part that's heating up in the market and we like the fact that your portfolio is getting bigger and bigger in healthcare right now, but it's not Medicaid healthcare, it's private pay healthcare. Joe T. San Agustin: Do they have insurance? Security Capital: They have insurance and they pay themselves and again we have to be very

careful that people can afford higher rents and that's what you want, you want higher rents. Interesting in your portfolio, the big thing is outpatient facilities, clinics and kind of skilled nursing rehab, probably the best part of the U.S. market right now is rehab hospitals. So that's been great and medical offices are very, very strong in the United States.

Wilfred Aflague: This transaction, was it in one state or across the country?  
Security Capital: Across the country. It's a very large portfolio and this company was aggressive, what they did was they bought, the operator was in trouble and they bought their debt very cheaply and so they can control what's happening and so now they bought the whole company in terms of they got a very good deal and that's why the market likes it a lot. That's a good point and we try to spread out your investments in a lot of parts of the U.S. economy, but we're trying to do is find whatever we can get demand generated right now and in aging America that's a good place.

Let me talk about a few pages on the outlook because it's been a great year. Let's look at probably the first interesting page, page 24. Page 24 is a good thing and a bad thing. Page 24 shows you in that dark line what has happened to the overall market companies that we can invest in for you and it starts at the peak in January 2007 and this is when a lot of the companies that we can invest in were taken private by companies that funded with really cheap debt and they're paying really high prices. So that was the peak in pricing in the stocks that we could buy. You invested at the very end of 2008, roughly around January 2009 is when you invested and since then it's been very volatile at the front end but it's been one way. There are 2 reasons why stocks have recovered. The first we've been talking about is cash flow. Cash flow with the bad economy, occupancy was going down, rents were collapsing and whenever you have cash flow from commercial real estate declining so rapidly, all commercial real estates are going to suffer. This was a period of time where the bad economy was really pounding cash flow. Since then cash flow in some areas is stable and in some areas is growing but the market is much more comfortable that they understand the cash flow of commercial real estate how bad can it get and they're now starting to price at how much better it can get because there's no building and the economy is starting to improve. That's one of the reasons we're going back up but there's a much more important reason over the last 12 months we've been going up and I'd like to focus on that and that's interest rates. Interest rates as we know went down very sharply, the 10 year Treasury certainly as the Fed tries to get the U.S. economy going has lowered and lowered interest rates. That's been a very important reason why the REITs have gone up and is the major concern over the next 12 months on short term movements in REIT prices. If interest rates keep going up, these stocks are going to wobble and in fact since the end of November when interest rates, 10 year Treasuries started to go up the stocks traded off a bit and they're volatile, they don't like rising interest rates. The combination of cash flow stability and lower interest rates is why we got where we are today. I'd like to

look at the concept of interest rates because I think that is, short term, our biggest concern.

Wilfred Leon Guerrero: There's 2 of you investing in REITs and one of them we held back funding it and I guess, I'm looking at this thing and I think we did the right thing by not... we had the thing in place, but we held back on funding because of the market. Security Capital: Your timing was superb. The key things that have changed since when you started and prior to that, let me turn to page 29, it's a complicated page but there's something very important on here. I'm going to explain this, this is so important for why you are making money and why your investment has turned out so well. These dots are the different companies they're ticker symbols in the stock market and what it's looking at is the rate of interest that they have had to pay on their debt on the worst part of the market and the best part. (Now I'm just going to look 2 dots on this page.) If you look at the far left, SPG a red dot, that's Simon Property Group, that's the largest REIT in America, they are the largest owner of regional shopping centers in America. They're a very, very big powerful company, \$45 billion, A minus credit, that's as good as it gets in the United States. At the worst part of the market when people were frightened of everything, they did a piece of debt and what this dot represents is the spread they had to pay in interest on this debt to the Treasuries. Now remember, they're an A minus credit, they had to pay almost 800 basis points, 8% higher than the 3% Treasury, they had to pay 11% for their debt. Now it's just a small piece of debt for them, they have a lot of older debt that is much lower rates. The reason why REIT stocks have rallied so strongly is when you invested, companies that were high quality like Simon were paying huge, huge costs for their debt and whatever they pay for their debt, it's not available for the equity which you own, so when debt costs are very high, it squeezes the equity and that's what the market was so worried about, that's why the prices went down so much.

The biggest surprise over the last 12 months if you go to the far right, look at SPG again, they just did a 10 year debt deal at 150 basis points over 3%. Okay, so the 10 year is the same, 3%, 3%, but the debt cost them 150 basis points, not 800 basis points. That is why REITs has been so powerful, because the companies that you invest in, the debt markets which were very, very expensive and afraid have gotten as tight as they have every gotten and the volume of debt available is huge to REITs, lots of debt, 10 year debt, fixed rate. Some of the companies have even done better, right now we have companies that have done 3.7% all in debt. Now that means there's a lot more money left over in the equity and the equity prices have appreciated that.

So, we've talked about cash flow, we've talked about commercial real estate, but commercial real estate uses debt. When debt was expensive and hard to get, the equity got crushed. The biggest surprise is nobody thought we could get back to 150 basis points spreads this fast. Nobody thought interest rates for REITs would go below 4%; they're now doing debt routinely at 4% or less. That is huge and one of the reasons why the equities have done so well. The

cautious part of is though, that's as good as it gets, we don't go lower. REITs have never gotten interest rates lower than they currently have today. What they have done on their balance sheets because they have lots of issues of debt, is they have aggressively gone out and pre-bid for debt that's going to mature in one, two, three years and they've paid premiums for that, to get it back, so they can quickly issue 10 year debt at these kind of rates. The good news is your companies, because you own blue chip companies with good balance sheets have aggressively restructured to this very low cost of debt and you're going to benefit because your equity is going to get more cash flow. The problem is the market now knows that and they've priced it in. Now what the market is going to be looking at is what happens to the 10 year and what happens to spread. We think spreads will stay fine, but if the 10 year moves up from 3 to 4, the new debt deals are going to be at 5, not 4. That will hold back the stocks for a while in our opinion, we think we're right in the middle of something where cash flows are going to get better but not for a while until the economy gets better, but even before the economy really gets noticeably better, interest rates are starting to move up because they were too low and so you're going to have this tug of war for the next 12 months. We don't know, our best estimate is you're probably going to make from here about a 10% rate of return plus or minus but with a lot of volatility based on interest rates.

SPG is a big part of your portfolio and it's a perfect illustration and I wanted to show it. The reason your equity has done so well is the debt has gotten so cheap and our concern is, maybe it can get cheaper, but if it gets cheaper then there's no growth in the cash flow. So you're at a tug of war right here where I think it's a timing problem. The cash flows won't get better until 2012 or 2013, but the debt costs are starting to go up right now. We're cautious, we think we've gone a long way quickly and we're delighted we have made these returns. Our longer term outlook is 10% rate of return. Gerry Cruz: What's the normal spread over this same period, what would be the average? Security Capital: Well this is not a normal period. Let's go back to page 31. Page 31 shows REIT bonds and if you look at REIT bonds, look at that teal line how it's spiked, that's when Simon had to pay so much money. If you look at the current on all the different REITs that issue bonds, the current interest rate is 4.4%. The historical average is 6.1, but of course the Treasuries are much lower and that's why on a spread basis, their current spread is 300 over versus a historical average of 268.

What we'll hold back making 20-30% rates of return is interest rates right now. Right now we buy debt for clients if they're in a different product line and we don't like long term REIT debt right now, it's too cheap. We like to own the equity of companies issuing long term debt, but we don't like to own the long term debt. In our debt products we're keeping our duration at 2-3 years, very, very short right now. We don't see there's a big opportunity in terms of the debt. Gerry Cruz: These are all fixed rates? Security Capital: Yes. REITs are very special right now because in the United States REITs compete with large private real estate companies. They can't issue unsecured debt because they

don't have investment grade ratings. If you don't have an investment grade rating, you really don't have access to debt right now. So REITs are very lucky, they have investment grade ratings and their debt is very, very cheap.

There's one page that kind of wraps up a lot of the thoughts and that is page 35. Page 35 is the page we tell you what we think REITs will return in the next 5 years, per year. How we do page 35 is as a firm we analyze all the cash flow from all the properties these companies own, but then what we plug in is a model that says here's all the cash flow, what discount rate do we need to bring all that cash flow back to current pricing. What we plug in is what's the market price of the equity and what's the market price of the debt. Right now roughly the 100 companies we can invest in you, the price of their equity and debt together is \$750 billion. That's what the market is paying for all of this and we know that the cash flow that all these properties are producing, so what's the discount rate that brings that back and this gives you a sense when the discount rate is high, it's a good time to invest in REITs, when the discount rate is low, it may or may not be, but spreads are very tight and they'll be very interest rate sensitive. Right now the equity that you own is at 10.2% and that 10.2% that means the discount rate the market wants on the equity is over 10%. That is a historically average discount rate for REITs, it's not bad, it's not good. The spread to the 10 year is 738 at that level versus the historical average of 743. That's not good, that's not bad, that's average. The problem is its spread to what and that's the one level of concern I'm going to bring today for you.

It's 2.8% Treasuries, that's what it was at the end of November. We know the 10 year Treasury is now over 3 and if that moves up to 4 and 5%, the stocks will probably have a pretty rough time with it. We're not talking about losing 25%, but they could go down 10, 15% from here in the short term. Our big concern right now is until we see more cash flow growth which probably won't happen until the economy works for a while is rising interest rates will make these stocks choppy. Gerry Cruz: When do you expect to see that happening, interest rates? Security Capital: JP Morgan thinks that we're okay for 12 months, we don't know, we don't know anyone that's good at interest rates. Here's what we do, we'll say we don't know if interest rates are going to go up fast or down fast, we don't know. Let's stress all of the companies in the portfolio to see what kind of debt do they have, what kind of occupancy do they have because if interest rates are going up because economy gets better and you own a lot of apartments with short term leases, the stocks will do fine. If you own a lot of long term leases like you own a lot of office buildings and interest rates are going up, they're not going to do so well. What we try to do in your portfolio is look at companies that number one have very long term debt in place so rates moving up in the short term won't affect their cash flow. We're also trying to focus on areas of demand is so good that they can surprise with better cash flow. We're just not owning lots of real estate because we don't know what interest rates will do, but we're trying to find real estate if interest rates go up faster than expected, you'll probably get some turbulence but you



will do okay. We want to stay away from areas that are weak where you're just buying bonds right now. We don't want to own bonds in your portfolio and we only own equity but there are some stocks that act like a bond because their cash flow is not going to go up even in a better economy.

So, we stressed test it and that's why we focused on the apartments and that's why we focused where we have on healthcare, because healthcare, your leases are tied to inflation and that's really good, they automatically go up when inflation goes up. Here's one thing that might worry you, bonds are very sensitive to what happens to the Government's CPI indicators for inflation; 34% of the CPI is all tied to rental rates of apartments. That's how they use to estimate cost to housing. We just told you earlier that rents are started to pop hugely and they're popping even without the economy doing better. Beware of the CPI because all of a sudden it's going to start acting very strong as they start moving the rental rates because they use rental rates to give an equivalent to cost of owning a home, so that's how they do it. Rental rates went down so much that everybody said the inflation is good, there's no inflation, all of a sudden it's going to be an issue out there and it's going to be rental apartments are going to have huge impact... Joe T. San Agustin: As long as the housing market goes up... Security Capital: Right, but it's going to odd because all of a sudden CPI is going to go up because the cost of housing is going up, but it's not, the rental is going up, but they use the rentals to estimate what the cost of housing is. What they do is they estimate what it would cost to rent your house out and they say what are rents doing in the local area and when rents go up they say your house is worth more. Over time if rents go up your house will be worth more. One of the reasons the CPI has been so low which is good is rental rates went to heck, right. But now with the rentals going up we want to be very cautious on interest rates, so the only thing that we know about interest rates that other people don't know, we don't know exactly where they're going because of the economy, but we do know that the CPI is a very interesting number right now on how it's calculated and we do know that the market will probably be back to back 3 years of 7-8% rent growth and that's a third of the CPI.

Wilfred Leon Guerrero: Terry (Dennison), I'm looking at the holdings between Security Capital and Cornerstone and there are about 16 securities that these guys are overlapping. When do we start worrying about... Terry Dennison: Well remember, there's only a universe of about 100, so it would not be surprising... Wilfred Leon Guerrero: I understand that, but if we have 2 money managers and they're all investing in the other extremes and you have 2 money managers and they're all investing in the same thing, you don't need one of them. Terry Dennison: One of the reasons we have 2, the 2 are very different, there's going to be some overlap. Wilfred Leon Guerrero: 16, I counted. Terry Dennison: How many in your portfolio, how many names in your portfolio? Security Capital: 25 and one thing you would want to look at, I think you're right, number one there are 50 REITs that matter, but what our firm does and I don't know about the other firm, we over weight, look at the weights of them because

they're probably quite different. Wilfred Leon Guerrero: I'm asking my coach here, when do I start worrying... Terry Dennison: It's very asset class specific, if this was Large Cap Value, I would be worried if there was a 50% overlap. In this space I wouldn't be worried because again, the weighting is different and the philosophies of Cornerstone and Security Capital are so different, but they're fishing in a small pond so you are going to get some overlap. I wouldn't be worried about this.

Security Capital: So I guess the summary in my message today, the good news is cash flow has stabilized and where we focused you're starting to grow and that's great. The caution note is interest rates, we try to position you the best we can that if interest rates unexpectedly go up over a 2-3 year period you would be fine, but that would be short term what could cause some turbulence in your portfolio. Gerry Cruz: What are your thoughts on the Treasury's efforts to ease, with their latest round of easing? Security Capital: Since they have been easing, interest rates have been going up so I don't think it's going to work very well, but I think what the market is saying is, thank you very much, the markets are actually healing already. Gerry Cruz: Do you think they will stop? Security Capital: I don't know politically if they will. I'm a REITs strategist... Gerry Cruz: What's the impact of that if it doesn't work and in the long run if they continue to do it? Security Capital: Inflation and if they do it and they don't bring the punch bowl, as they always say, back fast enough, they're job is... when the party gets going to take the punch bowl away. (Ben) Bernanke's presentation on 60 Minutes was very odd, he was very, 100% certain that the Fed will take interest rates, they'll do what they need to do so inflation's not a problem. I thought that was a non-sense statement.

You own these securities because long term they will respond well to inflation and they will only respond well to inflation because they're a scarce commodity, their rents are going to go up faster. Anything if there's a jolt in inflation, I think all financial securities are going to have a period of time that would be very turbulent, but these will probably, in our opinion, because their values will go up with inflation if for the simple reason it cost more to build them and so the rents will have to go up. I think that you'll also find because this is one area that interest rates are locked in for such a long period of time that they will have the ability to get their cash flow going so they won't have to cut dividends or anything. One of the reasons we own such a large position in a company called Public Storage for you is Public Storage doesn't use debt, they only use perpetual preferred financing and because they never have to pay it back and it's fixed funding, any surprise in inflation goes in the pocket of the equity holders of Public Storage out of the pocket of the perpetual preferred holders. So the best inflation hedge because number one, storage rates are going up actually sharply in America right now and if inflation is a problem, they'll go up faster, their fixed cost will never go up in that environment and so the biggest inflation machine that we know of is Public Storage. You want to own lots of public storage in an inflationary environment. It's not the only reason we own Public Storage, but it's in the back of our minds that's one of the reasons you

own so much Public Storage, it's the only company that we can invest in that has no debt, but they have a lot of fixed rate financing in their perpetual preferred. You don't want to own their perpetual preferred, by the way. It's very interesting you have an instrument you never have to pay back, but it has a fixed payment, that's a very odd thing that only REITs have.

Gerry Cruz: This is off the subject, but who would buy that? Security Capital: It's a very high income of perpetual preferred who never cut their dividends or omit them because their cumulative, they're always paid unlike financial preferred. If you're not worried about inflation, you'd get 7.5-8% returns in income and that's pretty high.

(End of presentation by Security Capital Research & Management)

### **2:00pm-2:45pm Cornerstone - REITs**

Wilfred Leon Guerrero: Thank you very much for coming. You can say anything you want to, but for our part, for our fiduciary responsibility, you need to discuss your performance last year, what do you expect this year, whether any regulatory agencies have issues with you, whether there have been any changes in your personnel, you can say anything you want to, but you need to cover those areas.

Cornerstone: Okay, that's fine. Thank you for spending some time with me, I appreciate it. I just went over what is expected in my presentation here and this is what's in the book here. I'm going to go to page 3 and talk about the organization. We have had a lot of changes in the organization, none of which are directly affecting the securities group that I run, but are affecting the company overall and I think all of it is positive in the sense that the company has become larger, more diverse, has more capabilities at its finger tips and I think in large complicated markets that we face today, that's always helpful.

Last year when I was here in December we talked to you about the potential for a couple of transactions with the company in that we're eminent and those transactions since closed. One of them was the company was merging in the real estate finance group from Bapson Capital Management which is another wholly owned subsidiary for Mass Mutual which we are a subsidiary of Mass Mutual as well. We always interacted with the real estate finance group, but now they're actually part of Cornerstone and what that did is it increased the size of the company from about \$10 billion to about \$30 billion and it also gave us a direct, although we interacted with them in the past, it gives us some sort of direct input or contact with the finance group. Why is that important and I think the credit crisis that we've just been through and in some respects still lingers in some markets, there's no question that having the knowledge, first hand knowledge of what's going on in the credit markets from people who are really on the front lines of extending credit to the various investors out there it's very, very helpful to us to understand what's happening there.

Another transaction that happened was the company acquired a company that was called Protego which is a European direct investment company and that company is now called Cornerstone Europe and they are based in Europe, they have offices in the Netherlands and also in Sweden and they give us a direct investment capability in Europe as well. Both of these things are positive for the securities group because they give us another form of input from the debt side and also on the equity side because we do manage both U.S. and global portfolios. So for us this transaction not only makes us bigger and more diverse, but they also allow us to have more access to information.

This is just a brief review of what we do and what we're doing and none of this is really new to you. Essentially this is basically the capabilities we have within the company itself and now that we have the real estate debt capability we do make investments in whole loans, commercial real estate and also CNBS debt and residential loan pools. So we have a complete selection of different types of investments. This is just the different types of investments we currently invest in right now. As you can see this is broken down between direct investment which is the upper left hand box here, debt investments which are in the lower left hand box, real estate securities which are global and then also the property types that we invest in the direct side of the shop. Wilfred Leon Guerrero: The office that you have in Hong Kong, where are they investing, in Hong Kong? Cornerstone: No, they are global real estate securities effort and essentially the Hong Kong office is responsible for covering all of Asia for us and they also cover Australia. So they are essentially covering China, Hong Kong, Singapore, Japan, Australia, you name it, every part of Asia you can imagine. Their investments for the most part are limited to public real estate companies. They have assisted some people with some direct investments but their investments, their efforts are primarily devoted to the real estate securities effort as part of our global effort.

Wilfred Leon Guerrero: Did you hear anything about wanting to invest here on Guam? Cornerstone: You know the public real estate companies are really focusing their efforts right now on the mainland, China and also in Hong Kong, there's a tremendous amount of money coming off of the mainland that is looking for a place to go and a lot of that money does go to Hong Kong. In some respects I wish it was more diversified across this region of the world because it has caused some property markets to get over heated and I'm sure you've heard some concerns about over heated property markets in Hong Kong as well as mainland China and in other parts of Asia. So right now there's an awful lot of focus on residential investment and we think it would be better if that money was more diversified across the Asian economy. (end tape 2)

(tape 3) They're not spending that money to stimulate the economy. You need to recognize that people need to get their balance sheets back in order and they need to be compelled to spend money and people are trying to do both right now, it's going to take a while for that to play out. Having a high corporate tax income rate is a difficult problem for the U.S. and one that I think we need to

fix. Gerry Cruz: So taking this forward, QE2 and the impacts of that if it's not successful, doesn't create the jobs, it doesn't stimulate the economy, what can we expect or what impact should we expect on our REIT portfolio? Cornerstone: I think what you're going to see is that right now the positive momentum in the market is that companies that have shorter duration leases like the hotel sector and like the industrial sector, these sectors right now are getting a lot of money put behind them and part of the reason for it is because they're starting to see growth in the economy that is helping the companies with the short duration leases grow their net operating company. A sign of that is if you look at a REV PAR part which is an acronym for revenue per available room in the hotel room is something they use to measure progress in both revenue and occupancy. If we get a continuation of momentum in the market right now, those companies would continue to do well, but if that momentum should subside... Gerry Cruz: And it would subside because of things like what, high inflation or...? Cornerstone: It would just subside because people and corporations would pull back, basically their business would pull back, your tourism will pull back and what's going to happen is companies that have hotel companies and industrial companies that basically, industrial companies are doing better right now because you're starting to see growth in trade in the U.S. and these companies directly benefit from it and since they have shorter duration leases they are allowed to benefit from it. So those 2 sectors are benefiting a great deal. If we saw a complete retrenchment in the growth and demand, what we would do is we would move the portfolio to longer duration assets to companies that have long term leases with a lot less growth for the most part but companies that will have continuous cash flow throughout that sort of down flow in the economy. Right now we're projecting that the economy will grow by 2.5 to 3% and we think that the companies with the shorter duration lease will benefit from them.

Gerry Cruz: Okay, so in our portfolio what kind of impact do you see on investments that you have that are direct versus or is it the same...and investments that you have... Cornerstone: In the securities arena...what we're seeing in the direct arena is that their lead times are slightly longer than ours because they're basically looking at a longer term holding than our investment process and what they're doing is they're starting to ramp up for what they consider to be some growth particularly in 2011 and 2012. One of the areas that they're looking at is they're looking at the apartment sector and the apartment sector, one of the areas they're looking at doing a development portfolio in the arena. Gerry Cruz: So you guys have direct investments in actual apartments? Cornerstone: We do, quite a bit and we have been very successful in that arena and we've developed apartments all over the United States. Gerry Cruz: Any where particular doing better than others? Cornerstone: Washington D.C. right now is doing incredibly well, New York is doing well, parts of Boston are doing well, some parts of California are doing well although California is a very mixed picture. Some of the things that we see as a positive momentum in the apartment arena is that we've had very limited new development in the apartment arena and despite the fact that job growth

has been somewhat limited, there has been demographically, there's a huge in the number of households that are being created in the United States because of the age --- that exists in the United States and the people, essentially the 18-24 year olds, that segment of the population is growing quite a bit. The only thing that has really helped --- up until now has been limited job growth. The other thing that is positive for the apartment sector is because people are uneasy about the housing market, there are many people out there that have the income and the credit quality, credit history to go out and buy homes or condominiums but are not doing so because effectively they're short on the housing market and because of that companies like Avalon Bay Residential which we have large positions in are companies that we think looked pretty well because these companies catered to higher income renters who have all the financial resources to go out and buy a place but have chosen not to because of the uncertainty of the housing market. There are still people out there who think the housing market could drop by as much as 10-20%. There's a wide degree, a wide variety of opinions out there, but we think the housing market could drop for a number of reasons, in fact, we did a little study on it and came up with half a dozen reasons why the housing market could drop further in the U.S. and we only came up with one reason why it would go up. Gerry Cruz: What would be the reason it would to up? Cornerstone: The reason it would go up is because there is no new supply, there are a lot of people sitting in apartments right now who want to buy homes, but are afraid to and we do have very low mortgage rates. If you take those people who have the capability to buy homes, if they feel that the process has bottomed, the problem with the housing market in the U.S. right now is that there are a number of reasons that give people reasons to be fearful. One is that there still are a large number of foreclosures in the pipeline in the U.S. that have yet to come out of the market. Once they come out into the market, that's going to create a lot of new supply. Gerry Cruz: But the foreclosures that haven't come out to the market because it's being artificially held back by regulation or it just hasn't been pushed? Cornerstone: Both. You have got regulatory hurdles that are causing these properties not to come to market, the other thing you've got going on is you do have some potential for tax increases down the, that could --- for housing in some respects and there's also a concern that part of the new, if you're familiar with the deficit commission that was put together, there were a couple of ideas that were brought about in those meetings that would be somewhat detrimental to the ownership of housing. One of them was taking away the right to deduct interest payments for purchase of a house, another was to take away the ability to deduct real estate taxes for purchases of a house. All of these things which are very positive for the housing market right now would be somewhat detrimental. So all of these things are causing people who are potentially able to buy a home to rethink it, to basically think it through and to be perfectly honest with you, I can't blame them because if I were in their position, unfortunately I own a home, but I think if I didn't own one I would be somewhat hesitant to buy one myself. The good news is that's positive for the apartment markets.

Page 11, I already talked about some of these things in my previous discussions. Corporate balance sheets are strong, the economic outlook is growing, but it's not growing enough to reduce the unemployment rate. I think the thing that I fear the most is if you have economic growth in the 2.5-3% rate, that's probably enough grow to significantly reduce the unemployment rate. We're close to 10% and obviously having 10% unemployment in the U.S. economy is a drag on the overall U.S. economy because you have people who can't spend and you also have the cost of providing unemployment insurance to these people and those are concerns. On the positive side as I talked about earlier, the U.S. tax cuts and also the proposed cuts in payroll taxes and the proposed cuts in the corporate income tax I think are very positive for the economy. Gerry Cruz: That goes into effect when? Cornerstone: It's suppose to go in effect January 1<sup>st</sup>, there's a big debate in Congress right now about how that is actually going to happen because you have a lame duck Congress that could try to delay it and the truth of the matter is if they do delay it, they're really kind of kidding themselves because the new Congress that comes in, they'll go ahead and pay us. Gerry Cruz: This includes payroll taxes? Cornerstone: Yes and it's the amount we talked about previously, it's about a 2% decrease in payroll taxes which I think is a very powerful stimulus package because it impacts every tax payer.

Unfortunately there's no magic solution, unfortunately we need to de-lever people's balance sheets, we need to stimulate corporate spending and capital spending and job creation, but that has to come from ultimate demand. Gerry Cruz: But nobody is going to invest if there's uncertainty. Cornerstone: Right. If you think about it, if you took away all the uncertainty that corporations have associated with healthcare, legislation, with corporate income taxes and just with employer payroll taxes, all of that I think would give corporations a modest push towards trying to put out some of that money. I'm not saying that it's going to automatically going to make things turn positive, but when you take away all those uncertainties I think it creates a more positive environment. Gerry Cruz: It does because you can plan, but if you don't know what regulatory costs would be, it's tough. Cornerstone: When you look at it from a very 50,000 foot macro point of view, the country, the U.S. is currently running their budgets on, their Government spending is about 25% of the overall GDP, in order to be a really competitive economy in the global economy, it needs to be somewhere closer to 19%, maybe 21% at the highest. The only way you can get there is you need to do one of two things, you either need to grow revenues or you need to cut expenses, but somehow you have to get there otherwise I just don't think you could be that competitive and we all need the U.S. to be competitive because it's not only important to the U.S., it's important to the Asian economies and everything else, because unfortunately as much as China would hate to admit it, they need us too and I think that's an issue.

Page 11 is basically our view of the economy and the sovereign debt issues that I spoke about earlier. It also has our economic forecast and this forecast does not have the payroll tax cut embedded into it, they think the payroll tax could

increase GDP by anywhere from 50-70 basis points so we could see some higher numbers here assuming everything else stays equal and the payroll tax reform does go through.

If you go to page 12, this basically looks at what's happening with the property markets, as you can see, the property markets have bottomed and are starting to work their way up. A lot of this has also had to do with improvement in the credit markets, it also has to do with the fact that there's no new supply, it also has to do with the fact that the growth in the economy is starting to stabilize as well.

Wilfred Leon Guerrero: Going back to page 11, employment growth, is that net? Cornerstone: That's net. Wilfred Leon Guerrero: You expect the unemployment rate to be reduced by 1%? Cornerstone: This is growth. The thing that you have to realize is that in order to decrease unemployment in the United States, you have to create somewhere between 150 and 175,000 jobs a month just to deal with the new people coming into the labor force. Wilfred Leon Guerrero: You're saying it's going to grow by 1%, that doesn't necessarily mean that unemployment rate is going to... Cornerstone: It's not because if everything was static, you didn't have new people coming into the labor force and you grew your employment by 1%, your unemployment rate would come down, but unfortunately we have an economy with a growing population, a growing labor force and in order to off-set that you need to generate about 150 - 175,000 jobs a month to just deal with people coming into the labor force and then you have to grow beyond that in order to take the unemployment rate down and that's a major challenge right now.

As you can see the property markets are starting to improve and I think this is very positive for definitely the REIT market. If you look to page 13, I want to talk a little bit about what we call the trifurcation of the property markets in the U.S. and essentially what this is looking at what we call the high barrier markets, in other words the cities that are difficult to develop in like Washington D.C., New York, Boston and you can see these sort of trophy cities that are listed here on the left hand column. Those property markets have rebounded pretty strongly and part of the reason for that is because there's very limited supply there and there's both demand, both domestically and internationally, particularly in markets like New York and Washington D.C. there's a lot of off shore money that's looking at those property types and especially when you look at what's happened with the U.S. dollar, it makes it an even more attractive bargain for off shore investors. So those markets have rebounded pretty strongly. On the flip side of that the distressed markets which is the red line here have really only started to rebound and those markets continue to struggle and we think they'll struggle for a while and that is one of the reasons why our portfolio is heavily concentrated in what we call barrier markets and this six city market is a component of the barrier markets.



Gerry Cruz: The red line, what markets are those, what areas are those?  
Cornerstone: Those are basically markets that are middle markets that have limited demand and in some cases they even have supply coming in to those markets and they are basically what we call secondary markets. Terry Dennison: Would those be like Phoenix and Las Vegas or small cities?  
Cornerstone: Both. Phoenix and Las Vegas are extremely distressed cities. If you're familiar with the residential markets there, it's just a sign of what's happening there, property markets there have dropped by 50%, in some cases more and you have got houses that are abandoned, you have got developments that were started and just ended by the developers and these markets are going to take years and years to recover and if you have a lot of courage and a little bit of money you could make some great investments there, but you're going to need to wait it out because these home prices have dropped dramatically. We have been particularly tracking the Phoenix and Las Vegas markets. Some parts of southern California, particularly the Inland Empire are very, very troubled and the Florida markets are incredibly troubled right now. One of the things that we do to get a better handle on the housing market and its impact on apartments is we do track the home building companies and one of the home building companies out there, Toll Brothers is a very large national builder, they build what I would consider to be higher end production type homes and what they do on some of their earnings calls is they give a letter grade to each one of the housing markets that they have developments in. Not that long the CEO gave a letter grades from the market and when he got to Florida he didn't even bother to break it down between the individual metropolitan areas, he basically gave the entire state an F. We just have a lot of properties there to deal with and it's very troubling.

I'm going to go to page 16 and talk a little bit about your portfolio and some of the things that we see going forward. As I said earlier in the discussion, one of the things that we are trying to capitalize on is those companies that have shorter duration leases and those companies that we think are going to be able to profit from a growth in the economy and they're also going to be able to profit from some increases in inflation that we see coming down the road and because of that we are over weighted in some of these sectors like industrial and hotels that shorter duration leases that could benefit from that. You're under weight in sectors like healthcare and office for a couple of reasons. One is healthcare has very long duration leases, healthcare tends to be more interest rate sensitive than other parts of the REIT market and office one of the reasons we're so under weight there is because other than a handful of other --- markets, we think the growth in demand for office product particularly the secondary market is going to take a while to basically recover so we continue to under weight office products because of that. Gerry Cruz: Residential, that includes multi-family? Cornerstone: Well it's mostly multi-family, there's also a segment in it that is basically manufactured home communities, it's a very small part of it, but what it is, is what you might refer to as trailer parks. Some people kind of smirk when they hear the name trailer parks, but it's actually a pretty good investment. The people there have plenty of reasons to stay

because they take because they've taken their manufactured home and they literally anchored it to the ground so it's not like its on wheels and they can pull it out at any point in time. Some of these manufactured home communities have amenities like golf courses, tennis courts and swimming pools and those types of things and I think you really have to have sort of an open mind to it. Because people are somewhat anchored to their spot, they do have minimal desire to relocate elsewhere, so it's actually not a bad investment.

If you go to page 17, the basic characteristics of the companies in our portfolio versus the Dow Jones RESI index as you see pretty similar in terms of dividend yield and market ---. We hold about 43 stocks in the portfolio which is about where we're comfortable right now and that's really about it.

If you go to page 18, these are our top 10 holdings. I just want to comment on 3 sectors as they impact the portfolio. One, as we have a very large weighting in both ---- Properties and Simon Property Group, both of these are regional mall companies, they both cater to upper income shoppers. One of the things that is occurring is consumers are spending more particularly the top quartile consumers, we believe these companies will profit from that we believe there is also some --- up demand from the last couple of years over the holidays and we think that part of the reason that these people are shopping more is that the improvement in the stock market generally has a very high correlation to consumer spending particularly for the top quartiles and because we have had this massive recovery in the stock market, that has helped consumer spending quite a bit. We also have an over weight in hotels, the one name on here, Host Hotels, which is this is basically due to the trends we see the --- growth that I mentioned earlier is 6-8% and virtually no new supply.

The last thing I will point out here on a sector basis is that we do have large weightings in the apartment sector, this is basically due to everything that I talked about, the upper income consumer not wanting to purchase a house, the demographic trends that are in place and the really limited supply of product that's coming in the market. Gerry Cruz: But you are kind of under weight on residential? Cornerstone: We are, but we are over weight in those areas that are those names that are most effected by or most impacted by the higher residential tenant. We're under weighted on those sectors where people have less ability to deal with rental increases.

The next page is our performance; this is a little bit out of date. We're about 140 basis points over our benchmark this year and overall it's been a challenging year for all of the reasons that we talked about, not the least of which has been all the repercussions with the sovereign debt issues in Europe and the challenges in Korea and China and every place else.

One sort of last bit of advice I'll give you is a parting word, we really think it makes a lot of sense to invest in stable diversified economies, we think it makes sense to invest in markets that have reasonably stable currency and we also

think it makes sense to invest in places with stable credit markets. One of the challenges of investing in today's world is that there aren't too many places like that and it's a real challenge for all investors and particularly for Boards like yourself and consultants that assist you to really navigate through those markets.

Thank you so much, I appreciate your time.  
(End of presentation by Cornerstone)

**3:00pm-3:45pm Atalanta Sosnoff Capital Corporation – Domestic Large Cap Core**

Atalanta: My name is Kamani Kuala'au and I have been with Atalanta for about 4 months now replacing the late Jim Staub who was I think all of you knew and was a very good friend to Micronesia. I got to know him in the last 5 years and he actually gave me a call expressing in my picking up where he left off and I am very appreciative of his generosity and I'm glad to be able to follow in his foot steps here. I worked at Bank of Hawaii before that for a firm called Public Financial Management in Philadelphia. I also want to introduce Jack McMullan who is one of the portfolio managers that manages all of our accounts with Atalanta Sosnoff. He is also a partner with the firm so he is representing all of our partners here today. He joined Atalanta in 2001 and is a graduate of Wharton School at University of Pennsylvania and New York University. With that I'll let Jack go through the performance and the fiduciary issues that you laid out.

Jack McMullan: Good afternoon. It's been about 4 years since I've been here so it's nice to see everybody again. The way I've outlined the book is to just go through performance, your account and I'll go through some brief economical reviews and how the portfolio is positioned.

If you go to page 1, it shows performance in the last fiscal years on this page and a couple of take aways. First it's really been a roller coaster with the last couple of years. In 2009 the market was really in a recovery mode after a very steep recessionary period and a much stronger performance in 2010. During the course of 2010, we lagged the benchmark by about 500 basis points and there are really 2 main causes for that relative under performance and I'll go through that in a few moments.

If we turn to page 2, fiscal year to date, the good news is off to a very strong start. In October we outperformed the benchmark by about 1.5% and another 1.2% in November, so off to a very strong start as we sit here for the remainder of the year.

Longer term performance is on page 3. This shows performance since inception which was in 1986, both on an annualized and accumulated basis and you can see on an annualized basis we outperformed the benchmark by about 1%, give

or take. The composite has changed over time and see the break down of the composite is on the bottom, but over this time period roughly 1% out performance.

I'll spend a few minutes trying to detail causes of under performance for the year and as you can see there are really 3 main causes here. What I like to first talk about are the headline stocks and that was roughly 200 basis points of the 500 basis points of under performance. By headline stocks what I mean are things that we can't see coming, things that we can't model for, they sort of come out of left field. It happens to every money manager every year both positively and negatively, but the reason we highlight here is it had such dramatic impact on results. The 2 stocks here are really Goldman Sachs and Hewlett Packard and Goldman Sachs was roughly around 125 basis points in the most recent fiscal year and you're probably aware, the SEC sued Goldman Sachs, it was subsequently settled, but it was a major position for us when the lawsuit hit the headlines. Hewlett Packard, when Mark Herd resigned he was a proven winner, he turned that company around and that was 60 basis points of under performance. Luckily we did own Oracle where he did go to which helped to offset that a little bit, but nonetheless, 60 basis points there.

The next major impact here are the financials which are roughly 1.6% of under performance and they really hurt us in this time period, but they've been big winners for us since we bought them in March and April of 2009. Quite frankly I think we really just missed an inflection point in these stocks. We bought these stocks in 2009 and really under the premise of an improving credit cycle, loan losses would get better, credit would get better and that's exactly what happened, but over the course of 2010, the market became very focused on these firms ability to generate revenue growth and you weren't seeing any loan growth and really the credit story sort of played out and we really missed the inflection point, so that cost us 1.6% this year.

Healthcare, roughly another 150 basis points, a similar story, 2 stocks that are long term winners for us that were hit with some off news and the rest is explanatory here. Roughly 200 basis points of the 500 are really issues that we couldn't see coming, but nonetheless had a dramatic impact on the portfolio.

Before we get into the outlook I would like to go through the account summary here. The account incepted 4/4/1986 with \$43 million, we've had roughly \$191 million withdrawals and \$234 million in performance. As of December 2<sup>nd</sup> the account is roughly \$86 million. Joe T. San Agustin: We started with \$43 million, we made money and took out... Jack McMullan: You took out \$191 million and performance added \$234 million. Joe T. San Agustin: We have twice as much as when we started? Jack McMullan: Exactly.

I have a lot of economic slides and I think what I prefer to do is talk through them rather than go through slide by slide here. Right now we're optimistic on world wide economic growth and the reason I say that is when you look on page

6, you can see that the European union and the UK are roughly a third of worldwide GDP and right now it looks like it's going to grow slightly sort of muddle through all the problems over there. The United States is 25% of worldwide GDP and quite frankly the economic data points have gotten much better over the course of the past month or so. We think the United States is probably going to grow around 3% or so next year. And then you get into the exciting parts of the economy which are the emerging economies and here we have Brazil, Russia, India and China which are 15%, but when you think about the emerging markets in total, they're roughly 35% of worldwide GDP today. So they're growing in the 7-8% range and with these developed economies, growing below trend, but growing nonetheless, it sets up for quite optimistic outlook on growth for next year. Now I mentioned that the economic data points in the United States are getting better as of late and when I talk about that, I'm really talking about data points as they relate to the consumer. When I look at the consumer, it's roughly 70% of our gross domestic product and what we're seeing now is we're seeing very muted, but positive job growth nonetheless and again muted but positive wage growth. So it's setting up a very nice back drop where personal consumption expenditures will probably continue to grow in that 3% plus range that we have seen over the past couple of quarters. I think we're at an inflection point where I think we may have a little bit of a kicker and it could grow a little bit better than that. What I mean by that is it seems as if the savings rate has stopped increasing and the pace of paying down debt is also starting to slow so you'll probably see more of that money that consumers are taking home actually go into the economy versus paying down their mortgages and increasing their savings rate. That could make the growth rate of personal consumption expenditures greater next year than we saw in 2010, which is a big positive from our stand point because that's really the foundation of our economy.

The next bucket of U.S. GDP is really Government spending which is around 21% of our economy and we got some very good news from that stand point last week with this new tax bill proposal. It looks as if that bill is probably going to add anywhere from half a percent to one full percentage point of GDP growth next year and that again is a major inflection point because the stimulus package is sort of on its last legs right now and that was actually going to be sort of a head win to growth next year and now Government spending could be at least neutral, probably a --- to growth next year. So, over the last month or so, the data points that have been incoming have been much more positive and sets a much better framework for U.S. GDP next year.

The last bucket I want to talk about are the emerging markets, as I've said are 35% of worldwide GDP. The big question mark right now and we sort of use China as a proxy and if you turn to page 15, a lot of the angst in the financial markets and economists view points over the course of the past year has been whether some of these emerging markets sort of engineer soft landings. China has been increasing their reserve rates, increasing their interest rates; they're trying to slow their economy because inflation is too high right now for their

liking. The good news is that their economies have such secular forces that are allowing them to grow through these tightening measures that they're coming out with the exact outcome which they wanted which is increasing reserve requirements, tightening monetary policy, but in the meanwhile, you can see their GDP is still growing in the 8% range which is the range they want to grow in. So, it seems as if they've engineered the soft landing that they wanted to which is a very positive data point from a worldwide stand point.

Our point of view here is European Union muddles through, the United States actually seems to be accelerating a little bit right now and the emerging market economies grow through their tightened measures in the 7% range and we're in the 4% range for worldwide GDP next year.

If you turn to page 20, this shows the thematic break down of the portfolio and this is how we tend to look at it versus an economical sector stand point. Gerry Cruz: Before you go on, since we're talking economics, do you see any head winds that may prevent some of that stuff from happening? Jack McMullan: Absolutely. When I mentioned the 2 forces that could make consumer spending better next year than this year, we're talking about a months worth of data points right now so it very well could be a blip, but you've seen the savings rate go from next to nothing to almost 6% and you've seen consumer installment debt really start to come down as --- income, it could very well reverse. It doesn't look like that's the case, but it's something that we're watching. The other head wind that we're looking at is really Government labor. Government labor is 16% of the work force and if we go back a couple of slides here, if you turn to page 12, this shows state and Government payrolls and again it's 15-16% of the total workforce. Look at what's been happening to state and Government payrolls, they've been --- on a downward --- and this is in the face of massive stimulus money flowing to the state and local level from the Federal Government. We had some very positive news from the tax front and payroll tax holiday last week, that probably won't turn this around. This is a big chunk in the labor force that's going the wrong way right now. Luckily private payrolls have been more than picking up the slack here, but this certainly is head wind that bears watching.

The other head wind that I mentioned and I'll just hit down a little bit more on page 16. I mentioned China has been really able to grow through their tightening measures. We're using that as a proxy for emerging market economies, but this just shows the emerging market economies inflation indices. A lot of these are running red hot right now, whether in Vietnam or Russia or Turkey can accomplish what China accomplished, I think that's yet to be determined, but the fact that China has been able to do it, Brazil has been able to do it, India is not on here, but India as well, we feel confident that it could certainly be on the margin, a head wind. Another point I want to take away here is the data points have been coming in more positively as of late. We're still calling for a 3% GDP growth next year which is number one, below trend and number two, not nearly high enough to make any real dent in the

unemployment rate. So we're talking on the margin things are getting better, but by no means is this going to be a robust recovery. There's probably recovery that you'll notice more in economic stand points, stock market indices versus real main stream impact. Gerry Cruz: So given that, do you see any major impact to things like unemployment, how do you see that play out? Jack McMullan: If you look at unemployment... Gerry Cruz: Income tax breaks, carrying forward with the Bush tax breaks, the breaks of payroll taxes, that's all great, but if you're unemployed, it doesn't make a difference. Jack McMullan: Right, you're 100% correct. Another way to look at is its additional money that's flowing into the economy, so it does have a real impact. Unlike the last benefits that came in one paycheck, the \$600 stimulus, you're going to see this in your paycheck every other week. But you're right, the unemployment rate, most models that I look at just is not going to go below 8.5% until the last quarter of 2012. So it's going to be a very slow steady recovery, but in fairness looking back 6 months ago, the big question was "are we going into a double dip recession" and that looks to be off the table at this point and it seems to be picking up steam. So by no means am I calling for 5% growth here and putting a 20 multiple on the market, we're no where near that type of scenario, but realistically the facts show we're on much better footing than we were 6 months ago.

If I turn back to page 20, the portfolio is really positioned 2 ways right now, a lot of these new products, innovation stocks in this first bucket, those are what we call the secular growth stories where there big tail winds behind these companies and they're going to grow at their 20% growth rate regardless if GDP is 2 or 4%. The next bucket is long cycle, think of Boeing and Deere. Boeing is an example where they have 5 years of planes in back log and as long as worldwide GDP stays positive, those planes are going to get delivered. The third bucket I elude to many times, emerging markets. 3M , 60% of their operating properties come from outside of the United States. Las Vegas Sands, 85% of their operating profit comes from Singapore and Macau. Restructuring and total returns, these are companies that are really transforming themselves. Ford massively restructured their balance sheet, their production profile, their production platforms; it's a turn around company that is now firing all cylinders. Credit normalization, Capital One is the only play we still have in this sector right now. Demand normalization, these stock names are still levered to an improving economy. One name I would point to is Starwood Hotels and Resorts, the key metric in that industry is revenue per available room and it's up roughly 8-9% this year, but if you look back to where we were in 2007 and 2008, we're still 18-19% in that level. So still a long way to go in terms of recovery. Gerry Cruz: You guys bought back Goldman Sachs? Jack McMullan: Yes we did in the 150 range.

I'm sorry for flipping back and forth here, but I'll sort of end on page 17. So we're optimistic on the outlook, we're optimistic on the market. Going back to your point, by no means, runaway growth here, but we think very realistic that the S&P500 could earn between 90 and 95 dollars next year. We look like we're

exiting the 4<sup>th</sup> quarter on about a \$91 run date, in the 3<sup>rd</sup> quarter it's about \$88, so by no means heroic assumptions here. Yes we're talking about very low growth in the United States, but 40% of the S&P500 earnings come from outside of the states. If our call is right for low growth, low inflation, I think a 15 multiple is very realistic, so you could be looking at a market any where from the high 13's to the low 14's.

So I think I will end it there. I'll just go back to the firm for a few moments just to talk about the firm updates. I don't know if anyone is aware in the room, there was a transaction that closed on June 1<sup>st</sup> this year where Evercore Partners took a 49% economic interest in Atalanta. It's purely an economic interest, all 5 of the equity owners have signed long term employment contracts, we retain complete control over the investment process and the daily operations of our firm, so it's really they're collecting a paycheck every quarter. Just to give you a sense, it closed June 1<sup>st</sup>, we have a quarterly meeting with them and that's it, it's really business as usual. It accomplishes a lot of things from our stand point, part of it is tax planning, estate planning from Martin, again Martin signed a long term agreement, he's not going anywhere anytime soon, but he had a very low cost basis in Atalanta from when he took the firm private in 2004 and at some point that had to be realized. Number two, I think it really ensures for the longevity of our firm, not only are all of us under long term agreements, but now when Martin, Craig or myself retire at some point down the road, there's an equity recycling program in place, so it ensures that all the equity of the firm is always in active participants which I think is a long term positive. So off to a good start, they've been a good partner to date; again they're taking a holding company approach to building out their money management business. The big bulk of Evercore's revenue and operating profit comes from investment banking advisory business, they're trying to smooth out their revenue and operating stream and it's a great pedigree, the individual that's running Evercore right now, his name is Ralph Shlosstein, he founded and ran Blackrock for 20 years so he understands that this business is an intellectual capital business and if the last 6 months are any indication, it's going to be business as usual going forward as well. That's really it for the firm updates. Right now the assets are about \$11.5 billion, flow has been positive every year since 2007 so the firm is on a very strong footing.

Thank you for your time everybody, it was really nice seeing you again.  
(End of presentation by Atalanta Sosnoff Capital Corporation)

**Respectfully submitted,**



**STEPHANIE A. HERRERA**  
Recording Secretary

**Affirmed:**



**Wilfred P. Leon Guerrero**  
Chairman