



GOVERNMENT OF GUAM  
**RETIREMENT FUND**  
 STABILITY • SECURITY • REWARDS

**Eddie Baza Calvo**  
 Governor

**Ray Tenorio**  
 Lieutenant Governor

**Paula M. Blas**  
 Director

*Trustees:*

**Joe T. San Agustin**  
 Chairman

**Wilfred P. Leon Guerrero, Ed.D.**  
 Vice-Chairman  
 Investment Committee, Chairman

**Antolina S. Leon Guerrero**  
 Secretary

**Gerard A. Cruz**  
 Treasurer  
 Audit & Operations Committee,  
 Chairman

**(Vacant)**  
 Members' & Benefits Committee,  
 Chairman

**Katherine T.E. Taitano**  
 Trustee

**James R.F. Duenas**  
 Trustee

**Defined Contribution Plan**  
**Quarter Ended September 30, 2012**  
**Quarterly Performance Meetings**  
 October 25, 2012  
 Retirement Fund Conference Room  
 =====

**Board of Trustees Present:**

Joe T. San Agustin, Chairman, Board of Trustees  
 Wilfred P. Leon Guerrero, Ed.D, Chairman, Investment Committee  
 Gerard A. Cruz, Trustee  
 Antolina S. Leon Guerrero, Trustee  
 George A. Santos, Trustee

**Staff Present:**

Paula M. Blas, Director  
 Diana Bernardo, Controller

**Other Present:**

Terry Dennison, Mercer Investment Consulting Inc.  
 Alice Taijeron, Great West Retirement Services  
 Doris Flores-Brooks, Office of Public Accountability

**Economic & Capital Market Environment**  
**DC Plan Performance**

Pages 2 - 29  
 Pages 29 - 35



## **Economic & Capital Market Environment**

Terry Dennison: Let's start by looking at the book in front of you and just kind of get a numerical summary of what went on in the 3<sup>rd</sup> quarter. We seem to be alternating good and bad quarters, if you remember 1<sup>st</sup> quarter was very good, the 2<sup>nd</sup> quarter was very bad and now the 3<sup>rd</sup> quarter was very good again. If you look at page 1, one of the things that's really quite intriguing about this is if you look at the bars for performance both for 3<sup>rd</sup> quarter and year to date most things did about the same, pretty much any

equity you wanted to be in was in about the 6's in the U.S. and 7 1/2 in internationally for the quarter, similarly on the year to date basis, again these numbers are pretty good with the S&P of 16.4 because remember we now had two good quarters and one bad quarter. So, there has not been a lot of differentiation, there's not the usual situation where one segment of the equity markets does very well and one segment does relatively poorly. If you look toward the bottom, the 2 commodities indices and if you filled your gas tanks lately you would know about this, did very well with energy prices generally rebounding. Interestingly on the year to date page the two real estate investment trusts, the U.S. and the Global were the best performing asset classes of just about anything but the global REITS have over 21%, so again real estate continues to do very well.

If we turn to page 2 and I'll go into much more detail about the economy but let's just go through these pages here. Basically the economists are forecasting that the growth in the 3<sup>rd</sup> quarter was up 1.8% which is not very strong particularly at this stage in recovery; this has been a much muted recovery. I've seen some analysis that would indicate a kind of instantaneous basis right now the growth may have fallen to a little bit less than 1.3%. The economy added 145,000 jobs in the 3<sup>rd</sup> quarter which is an improvement from the prior quarter but still very weak. We'll talk a little bit about the unemployment rate when I get to my notes.

If you look at the upper left hand corner you see a breakdown of what makes up GDP. Growth Domestic Product is actually the sum of a lot of things, we all remember that consumers are about 70% of GDP, that's the first line, the personal consumption expenditures and you can see that its contribution to GDP growth has been pretty strong, it's up 1.1%. Now one of the issues in the economy is that's substantially stronger than the growth in incomes and it in long term is not possible to spend more than you make because you must be borrowing so we're seeing a bit of a pick up in borrowing. Residential fixed investment housing is still very weak, there's been some improvement in the housing market, traffic in new model homes has increased, there has been some increase in building permits and the sense is that the shadow inventory of foreclosed homes which are always depressing prices which has probably fallen by about half so we are seeing a pick up in the housing sector but it's not showing up yet in GDP. Non-residential fixed investment 4/10ths of 1%, this basically is corporation's spending money on plants and equipment, and

this is another area of the economy that is weakening. There have been a lot of statistics that I found that indicate that companies are sitting on cash, they're not spending money to build new plants and equipment and they're not hiring, partly because of uncertainties about the political and economic environment going forward, so we are seeing a fairly weak number there. Government consumption is actually negative more at the state and local level where the state and local spending since the start of the recession in 2007 and 2008 has fallen dramatically and the change in inventory had a negative effect. The reality is this is an adjustment factor, if people make more than they sell, inventories go up, if they sell more than they make, inventories go down, but inventories can't fall below zero and eventually when inventories get very large they just shut down manufacturing. What we're seeing is the effect of change in inventories was negative so that's another indication that things are slowing. And finally the trade balance which is the degree to which we are a net exporter versus a net importer and that's how we got the 1.3% GDP.

The sense is that we're probably a little slower in the 3<sup>rd</sup> quarter, I'm sorry, a little better in the 3<sup>rd</sup> quarter, about 1.8% but still slow. The Federal Reserve embarked on another round of quantitative easing, this time they are buying agency debt about \$40 billion dollars a month, again trying to re-stimulate the housing market and to get money in the economy. One of the issues with the central banks, not just in the U.S. but around the world is their ability to stimulate the economy is limited because interest rates are zero. They can't reduce interest rates because you can't reduce them below zero. So, were now seeing another quantitative easing program there was a former Federal official who made an interesting analysis, he said "the economic effect, the effect on GDP at the introduction of the I Phone 5 is larger than what quantitative easing 3 will be. Quantitative easing just not make that must difference anymore, the first one was very stimulative and really was what got us out of the recession, because there are some factors in the economy that aren't true today, back then liquidity was very limited, the banks were starved for capital, there was very little liquidity in the market, so flooding the market with liquidity had a very stimulative effect, but each individual quantitative QE2, operation twist, all of these had the effect of becoming less efficacious, they produce less positive results each time, so the expectation of QE3 is going to be a fairly modest import. So we expect to see weak growth and elevated unemployment as the private sector continues to de-leverage.

We're going to spend a fair amount of time about the fiscal cliff because the fiscal cliff, basically about a dozen different simulative programs all ending on 12/31 is becoming a major factor in economy, while nothing will happen until 12/31, businesses are planning for it, they're reacting to it and that's why we see a lot of job reductions. I was looking at Bloomberg on my Blackberry today and there were some announcements of some very major layoffs, people are basically cutting the workforce.

I'm on page 2 about the middle of the right hand column. The ECB is also undertaking what they call outright monetary transactions which I'm sure even the name annoys the Germans. In order to buy short term sovereign bonds, this has an

interesting effect, the purpose of this is to support the insolvent Governments in the Southern peripheral states, the countries in Europe but they're only buying 3 year bonds and one of the problems that these countries have is not only are they running deficits that have to be financed, but they have to refinance or refund maturing debt, so if a bond that's been out for 10 years matures they have to issue a new bond. Well, they're not able anymore to sell long term debt, base in the ECB's OMT program will only buy bonds out 3 years so they're now on this treadmill, basically they have to constantly reissue debt, they have to constantly go out to the market because they can't get long term financing. The private sector will not buy the bonds and the international agencies, both the international monetary fund and the ECB and their various programs won't buy long term debt so actually while it's keeping the companies solvent today, it's actually long term making their life much more difficult.

If we look on the left hand page or the left hand bottom, looking at the world economic growth, if you look at the numbers for the world these are from the international monetary fund, their estimates as of September 2012, basically they're forecasting world economic growth to pick up very slightly in 2013, largely because the developed world is going to be about flat and the aggregate will be about flat and the emerging markets are still high single digits but down from the historic level.

I know for the economy of Guam, Japan matters a lot. If you look at what they expect to happen in Japan, they expect growth to drop significantly in Japan, partly because (Wilfred Leon Guerrero: Say that again.) The GDP of Japan which they're forecasting at 2.2 % this year is going to fall to 1.2%, so Japan which has been in a what, frankly recession for 20 years, their economy is going to turn downward. (Doris Brooks: But we are experiencing increased tourism.) Well, these two don't happen instantaneously. Most people they like to go on vacation and don't check the GDP numbers before they go, but the reality is it's going to become more difficult for the Japanese economy.

(Wilfred Leon Guerrero: And on this quarter, the YEN depreciated, but yet the numbers still increase.) Yes. Well, the YEN is one of those currencies that is getting and I'll talk a little bit about what's happening with Central Banks. Central Banks have been reducing their exposure to Euro denominated securities. Previously in the aggregate the Central banks around the world like the Federal Reserve, the Bank of England, the Bank of Japan and there's a Bank of Australia and Hawaii, they hold their assets in various currencies. The U.S. Government, the U.S. Treasuries is by far the largest but until recently about 29% of Central bank reserves were held in Euro, that's fallen to about 25%, they don't want to hold anymore dollars because the U.S. economy is in very poor shape, we're struggling with debt problems and we're in a pre-Greece situation in the U.S. (Doris Brooks: pre-Greece. See, everyone is saying that we would never be Greece.) Well, we can't speak Greek, that's not the only real difference. (Doris Brooks: No one can speak Greek.) So what's happening is that they're moving into a "safer currencies," well if the U.S. dollar is kind of off the board and the Euro is the problem, where are they going? They're going to countries like Switzerland and Australia and Canada, New Zealand, Korea, Brazil and Japan. (Doris Brooks: Speaking of Australia, how come

Australia and New Zealand are not listed in here?) Because we don't list all the things they would be in the category of developed Asia. (Doris Brooks: Developed Asia?) Yes. Obviously, particularly Australia, their economy is very dependent on Japan because a significant part of their economy is basically digging the place up, putting it into ships and sending it to Japan. As Japan's demand for raw materials declines so does the economic situation in Australia and for that matter, in Canada.

You can see it's kind of a mixed picture, developed Asia and emerging markets are going to do better. The U.S. is going to decline and the Euro area, they forecast to go from slightly negative to slightly positive, my guess is that's probably going to be revised downward.

(Doris Brooks: Well, we're hearing in the U.S. is getting better, is that because Obama is running?) Well, it's a political season. We'll talk more about, I have a whole set of notes which I usually do, we'll talk more about it but I just want to go through this more of quantitative picture first, it's a very mixed picture but there are some negatives on the horizon, one of them of course being that fiscal cliff.

Looking at the dollar, these are performance versus the U.S. dollar. You can see most currencies with the exception of the Brazilian Real grew in value versus the U.S. dollar, the Swiss Frank is a kind of a funny case, they've been running a peg against the Euro, because it's so easy to go from Euro zone into us, Switzerland is surrounded by Euro zone countries, they didn't want to see continued currency inflows into Switzerland, they're basically managing the currency so that they're not seeing so much in the way of inflows. The dollar also declined because of inflation concerns, debt concerns, so in any case the currencies, there is no absolute benchmark, they're all relative to each other so in one case this isn't things rose against the dollar, and rather the dollar fell against them which is basically the same thing.

Looking on page 4, how U.S. equities behave again as we saw pretty much any place in the market produced about the same return, we didn't see a big difference in large and small, growth and value, it's really quite unprecedented to see things so similar, usually there is one segment of the market that does well or worse than the others. In terms of sector performance on the left hand side on page 4, clearly there are differences. Telecomm services have been doing very well, financials have been doing very well, utilities relatively poorly, but not a huge spread.

One of the interesting things is on page 5 looking at valuation. Valuation is a term that investment people use basically how good a deal stocks are. Stocks are a good deal when you can buy a lot of earnings for a cheap price, they're a bad deal if you're paying an expensive price for that same amount of earnings. Right now on a classical basis when you're looking at Price Earnings Ratio, it's relatively attractive, 16.4%. Now the issue there is corporate profitability is extremely high and companies have been very generous in increasing dividends and the very high earnings have made paying a little bit more for stocks than what are pretty reasonable.

If you look at it on a historical basis they remain elevated and in fact if you look at it on a normalized earnings basis, we're looking at a rolling 10 year basis, it's over 20 which is probably too high realistically stocks are probably over-valued at this point.

Literally and we'll talk a little bit about corporate profitability, the numbers there are just extremely high, multi year highs. We are seeing stagnation of top line growth, I mentioned we're starting see a lot of lay-offs, company's right-size they've very reluctant to invest, they're cash heavy, but they've been very reluctant to invest because the future is not very clear. It would require profit margins to stay at these historical levels to be worth paying the price earnings ratios on a long term basis. One advantage of owning stocks or one reason to own stocks is very poor bond yields, bond yields are very low with no creditable view of inflation coming any time soon and Government keeping short term rates are at a very low level.

The long term rates are not really under the Government's control, those are more driven by the market but the sense is that there's no inflation (Gerard Cruz: But the buyers, doesn't that help to bring the rates down?) Right, but you're looking at it on more of a corporate basis. Yes, if you're looking at mortgages, you're buying \$40 billion a month, so they're going to keep trying to drive those rates down.

If we look to page 6, looking at international equities, again a very similar pattern, everything about the same, the Japanese market performing the poorest, the major markets in Germany doing about the best. Germany is beginning to slip into if not recession, more of a neutral area, they're growth was about 2%, it's down now to about 1%, it's still a very export driven market and that's great except if all your customers have no money it's very hard to sell to them or export to them.

The emerging market performance, particularly the emerging market Europe and the Middle East have been very strong. Asia, obviously driven very largely by China has also been strong, Latin America is a little bit weaker.

Looking at fixed income, credit spreads narrowed again, credit spreads are the increment of yield you get for investing in non-treasuries. You can think about the yield curve, the yield curve in terms of what the yield is for periods out to 30 years is having a shape generally like this, that's the treasury yield curve. Above that are the triple A corporates, the double A corporates, single A corporates, double B and finally a period of junk bonds, that whole structure has come down, the market does not see a lot of economic trouble in the immediate future an interesting indicator of where people or the market think, of course the market is important, this isn't just people making guesses on a Sunday morning TV show, they're spending real money based on these estimates.

Basically with spreads narrowing, the sense is that the economy is looking better, we'll see some data that points in different directions. Right now the economy is

much like the Presidential election, it's all over the place, you can find any numbers you want to have to indicate what's going to happen, we'll find that out soon enough, but there's numbers in every place, every direction you want to look.

One thing that's the interesting on the bottom of page 8, on the bottom left and it matters because you have, unusually really for participant directed plans, an international bond fund, and you can see that's been a very handsome place to invest, 12% on a year to date basis which is pretty good money for a fixed income fund, one of the better performing asset classes. If we look at valuation on international on page 7, when we look at non-U.S. equities, these typically are large multi-nationals. While they're not U.S. companies, they sell a lot in the U.S. they sell a lot around the world. So when we talk about non-U.S. companies, we're not necessarily talking about the local company in France or the local company in Italy, these are mostly multi nationals, so while the economy in Europe is doing very poorly, multi-national companies who can sell in the emerging markets and go where the opportunities are, generally have not been terribly negatively hurt, in fact on a valuation basis, Euro zone equities look very attractive, they are very cheap relative to the U.S., they're selling at about 7 1/2 times cash flow and that's a 23% discount from the U.S. Now obviously if there are serious problems in the Euro zone they are going to be impacted at least emotionally, but financially the impact is going to be fairly modest because they sell all over the world.

Emerging market stocks are selling again, relatively cheap, they're about 17% below our estimated fair value. That's not to say that the next minute they're going to go up 17%, but you're probably not over paying in terms of earnings. The remaining page is not particularly relevant to you, its alternatives, hedge funds and real estate.

Let's talk a little bit about how we see the world. Global growth has slowed to about 2%. Half a percent of the developed world and a little over 4% in the emerging world. We talked last time about a significant part of the world and recession and that's pretty much about where we are.

The weak demand is in the face of substantial, fiscal and monetary stimulus. The ability of Central banks and the Government to stimulate the economy is becoming weaker and weaker and weaker. Part of this is debt, part of this is effect of de-leveraging. We'll talk about de-leveraging in a little bit because it's really the factor that's suppressing the U.S. economy. (Gerard Cruz: But how do you get through that except to get through it?) You just have to get through it. I'm going to show you this chart. This is where we are in the U.S. This is debt to GDP. For a long time we were right down here at about 150% total debt to GDP and then we all lost our minds. (Doris Brooks: At what percentage is that?) That gets up to about 375%. (Doris Brooks: Right now?) Right now. (Doris Brooks: I have not heard that number.) This is total debt. This is not just the U.S. Treasury debt which is about 100% of GDP, this is state, local, businesses, individuals and this is total debt in the U.S. (Doris Brooks: Including consumers?) (George Santos: Including Guam?) Including Guam, including consumers. (Doris Brooks: Including Guam's debt of a billion dollars?) Yes. It's all in here. Now what this does not include is off balance



sheet debt. (Doris Brooks: What's off balance sheet debt?) We'll you're talking about Social Security, Social Security is unfunded? (Doris Brooks: unfunded?) Unfunded. So the reality is we dug ourselves a big hole and it's going to take a long time to get out of that hole and it's going to be real painful to get out of that hole.

Remember I gave you a little example a couple of quarters ago, you're making \$100,000 a year and the bank says, "hey, you're terrific, we'll loan you \$20,000 a year" and you do that for 30 years and now you're living on \$120,000 and all of a sudden you wake up and you discover you're a hundreds of thousands of dollars in debt, the banks says no more, you have to pay it back, but to pay that back at the rate you did borrow it, now you're living at \$80,000 a year so your disposable income has fallen 40% and that's going to have a significant impact on your ability to spend and the economy's ability to grow and that's where we are today. How are we going to pay this money back it's going to be the issue and it's going to slow the economy for years and that's this point, this kind of recession is different from the classical inventory recession. The classical inventory recession is business gets good, people caught buying stuff, stuff being made, all of a sudden there is more stuff than people are buying, factories shut down, they put people on short hours, the economy goes down, the Government stimulus goes back up again, there's is nothing to fix this other than to grimly paying it back, that's the comment about Greece, we're going to have to live in a much more austere environment.

If you're going to reduce your debt to GDP you're going to have to save more and spend less and if 70% of GDP is personal consumption expenditure, it's going to reduce GDP. (Gerard Cruz: So we need to get used to the lower GDP level, we need to get use to not expecting the V shape recovery and we need to expect that regardless of who is in office, or where the recovery is. Yes.

(Gerard Cruz: Because it's not uncontrollable and I agree.) (Doris Brooks: But the reality is I don't think it's going to happen, just yet.) (Gerard Cruz: But people have got to adjust their tolerance to pain, that's what they have to do. Nobody in the Government is talking about adjusting the tolerance to pain.) Well nobody is going to get elected if they told you the truth. Fundamentally that's the problem, anybody who will tell you the truth can't possibly get elected because the truth is ugly. Realistically we've been living beyond our means, we're just like a family that's run up every credit card, we're hocked up to our eyeballs and we're not paying our bills. Now we can pay our bills for a while because we can print money, but eventually the value of the money diminishes. (Doris Brooks: Well, the dollar is not worth much anymore anyway.) You know, if you have a bushel of wheat or a barrel of oil, at some point are you going to take pieces of paper for that? Then things start to get awkward.

We're seeing now, I've been looking at some of the earnings results and earnings forecast have been constantly being cut. Caterpillar, FedEx, Ford, Intel, T-Mobile and Boeing have all cut earnings expectations or reporting revenue shortfalls. This is even beginning to impact emerging market corporate debt. We've always had a high

opinion of emerging market debt but of course anything can become too expensive to be a good deal, there is nothing that's great at any price, price always matters.

Yesterday, Pimco announced that they're cutting exposure to emerging market corporate debt, they feel that the emerging market countries are going to begin to slow and there has been a lot of debt now that has been issued where we're not really sure we're going to get paid back.

Bridgewater which is an analytical firm we pay a lot of attention to did an analysis and they believe the developed world has lost 40 million jobs since the year 2000 to the emerging markets and the developed world share of trade has fallen from 75% to 60%, so that's why you see unemployment in double digits across Europe and nearly double digits in the U.S. and the European countries have this in spades because they have high debt, low levels of productivity and they're losing market share, not just interestingly to the emerging world, they're losing to shares to the U.S. because the U.S. is becoming more efficient, we're becoming a much more cheaper place to manufacture things and you're beginning to see the U.S. be competitive with the emerging markets.

From a long term perspective, there is another negative on the horizon and this has to do with demographics, one definition of GDP growth. There's multiple definitions, we've built that number up from personal consumption, expenditures and inventories and Government spending and alike. Another way to think of GDP growth is it's the product of productivity increases and work force growth. Now for about 100 years productivity has grown at 1.5 to 2% a year that for per labor hour, output has grown by about that much. Work force growth right now in the developed world is the lowest it's been in 50 years. We had a tremendous increase in the labor force in the developed world as women started to enter the labor force after World War II. If you look at labor force participation between men and women they're pretty much the same now, so the reality is that big increase in the workforce which was a part of the tremendous growth in GDP we've seen since World War II is going to happen again.

Japan has got a 1% per year decline in labor force. Their economy is shrinking, their work force is shrinking. We've mentioned before one concern about China is they will get old before they get rich. Their work force is aging because of the one child policy. The last 50 years global GDP growth has been about 3% which means that the total wealth of the world grows, it doubles about every 20 years. It is probably going to be closer to 1 1/2 % so the world is going to become less wealthy. If we talk about the U.S. early in the year we were growing about 4%. Second quarter 1 1/2 percent and probably 1.8 % for third quarter.

Most estimates are that you need about 2 1/2% growth to accommodate labor force increase maintained unemployment at the same level, so we are likely to see unemployment if it falls it will fall very slowly and it's more likely to go up. We only

see a modest increase in household spending remember we saw that 1% personal consumption expenditure in second quarter and retail sales are up about 3½% for 3rd quarter but that substantially above income growth that can't continue particularly because it's much harder to borrow money today than it was before. Something that Kagasenti, speak of his credit pipes. Credit pipes are things like home mortgages, second mortgages, car loans, student loans, all the different ways you could borrow money. Most of those pipes are actually closed in 2008. The basically banks are out of lending business nobody had any money. Most of the credit pipes are now open so you could borrow money if you could meet the underwriting standards but there really hasn't been much of decline in underwriting standards the banks are pretty tough in lending money.

We saw a substantial decline 3 tenth of 1% of unemployment rate, there is actually two ways they measure unemployment the official rate is coming for what they call household survey. They call up about 1200 households and ask are they people who are working or looking for a job. The problem is they don't differentiate between part-time work and full-time work. So this fall in unemployment was not due to permanent increases or increases in permanent employment but people more working part-time, including people who use to be working full time and now working part time. There is another survey called the establishment survey where they talk to business and that is a much more stable number that has not shown as much improvement. Some statistics about unemployment, again Bridgewater looked at unemployment for recession since 1970 and the average period of unemployment in recession up until this one about 20 weeks and the recession is 40 weeks, in the recession the percent of unemployed finding a job is 10%, which is much lower than the 30% it's been in the recession since 1970. I have recently risen to about 15 to about 20% since September 1<sup>st</sup>, companies in North America eliminated 62 thousand jobs that's the biggest decline in that period since 2010, and year to date 158,000 thousand jobs.

(Gerard Cruz: These jobs are going away are results of the sequestration threat.) The result of lack of clarity about the future and lack of clarity about taxation regulation, and some to do with the fiscal cliff. The government requires that if you are going to do a mass lay-off you have to file some forms, well some people doing that defensively. Some people are just getting laid off because not as much work as people are expecting. Corporations had become much more cautious because they have great growth potential, the reality there holding on to their money an there not adding on to plant equipment.

Corporations are very liquid there balance sheet are flutter with cash there not spending their not hiring people, their not building plants and equipment it's really stagnated. I think there is a sense across the board in Washington that if it looks good today everybody should go out and spend a lot of money. The problem is the businesses plan they want to have some assurance in what the conditions are going to be because if things turns bad they don't want to be caught out with money. So it's not that they think the economy is going to be terrible in creating that effect that the fact don't have any clarity what the regulatory environments going to be what the

economic environment going to they are seeing final sales rather than top line growth decline. I mean people are not spending much money and of course if business stop spending money the people who make whatever business buy don't have any growth. Non-residential fix investment thinks of that corporate plan and equipment that's really stagnated.

There is a statistic that gets reported on the 27<sup>th</sup> of September on what's called leading order of durable goods if you buy something that takes 18 months to build or 12 months to build, you have a sense of what people are going to be spending that is indicated to have contraction in the near term and the numbers were very weak. Export growth which was one of the few bright spot we had coming out of 2007-2008 is now pretty much zero. The survey by the institute of supply management the ISM survey is weak, one of these is the Fiscal Cliff. The fiscal cliff isn't one thing there are 11 stimulus programs that are all set to expire the same day. There are two set of tax cuts from the Bush Administration indexing the alternative minimum tax to 2% employee FICA, reduction extension of unemployment insurance, some tax increases from the affordable health care, 3 different kinds of sequestration, tax extenders like the R&D tax credit, and what's called the doc fix which is the Medicare reimbursement. All of these add up to major money some of are pretty small, the doc fix is 15 billion, unemployment insurance is 35 billion, the big ticket items are the Bush tax cut under 250 thousand a year that is 155 billion dollars.

(Doris Brooks: For incomes under) Yes. The tax cuts that were made for people whose adjusted gross income is under 250 thousand that cost 155 billion dollars a year. The tax cuts for people making over 250 thousand a year is only 55 billion. The defense sequestration is 55 (Doris Brooks-but the portion of people under the 250 is 95% - 99%) The FICA tax cut is 110 billion for the 2% FICA tax cut, so there is a lot of analysis made about what's likely to happen, now the interesting thing is, that there's not much difference in people's views when you aggregate it. Some Republican like this, hate that and some Democrats hate that love this. The net result is and I've seen analysis if they actually do nothing, if they just let it go over the cliff that some of it is 719 billion dollars it would instantaneously produce a severe recession that's a 4.5% of GDP.

So will be back to where we were in 2007-2008, (Brooks: If not worse) and nobody thinks that's going to happen. The interesting thing is that if you look at all the possible cases and I won't give you the billions because after awhile your head just spins, in terms of the percentages GDP is about 1.8% so any number more than 1.8% - recession, any number below 1.8 very, very slow growth. Obama Presidency split Congress 1.7% reduction in GDP, Obama Presidency Republican Congress 1.5% reduction in GDP, Romney Presidency or Public in Congress 1.6% reduction in GDP, Romney Presidency Democratic Congress 1.5% reduction in GDP, so the way that people looked at it.

(Doris Brooks: say that again, so all of them are almost mutual, so it does not matter who is President or who is Congress). In the aggregate it does not make any difference as long as they do something if they just let everything expire you've got a

horrific instantaneous recession overnight that's going to be very difficult to get out of. Nobody thinks that's going to happen but the interesting thing is, for each one of those cases what they keep what they don't keep is different. I actually have a chart that shows one organization, Pimco, what they did, is that they looked at what the platform says, how the people talk about and did some trial votes. So, the net result is, it almost does not matter what happens in the auction we're going to be about zero. There is no sense that the FICA tax cut will be eliminated, the taxes will go up, they will not extend that, there's no chance of that being extended, nobody wants to extend that. (Doris Brooks: In other words, we have to pay it, because that's 3 years already that is the employee side that's been talked about for some time, so that's going to lower consumer spending). Yes, absolutely. (Gerard: We calculated about 20 to 30 dollars on our average employee's pay check). In the aggregate it's 110 billion dollars. (Rosalie Bordallo: But, you always have to understand that 20 to 30 dollars for an individual depending on what their income level is it can be significant.) (Gerard Cruz: But, this is what they were paying before.) (Rosalie Bordallo: So, you're saying they never had a salary increase at all.) (Dr. LG: You guys don't understand.) (Doris Brooks: I think that you're right, Rosalie that the first time out, they're going to feel it.) (Rosalie Bordallo: yeah, they'll get use to it) (Gerard Cruz: My opinion, we just need some sense of certainty, this whole back and forth because you can plan for a bad situation, certainly you can plan for a good situation.) (Doris Brooks: Nobody plans.) Businesses plan. (Doris Brooks: Individuals don't plan.) (Gerard Cruz: You're trying to decide whether or not you're going to buy a new car or buy a new washer or whatever it is and you know your income is going down, then you can defer that expense. What you can't do is plan a deferral expense if you have no idea what's going to happen, I think that's the kind what's causing all the ruckus, there's just no clarity on what were going to do, so everybody's just saying that I don't know what to do, there's just like a paralysis) (Doris Brooks: Going back to the options that is almost a certainty. What else is almost a certainty) let me look at my chart (Doris Brooks: That's the only one I've been hearing, the FICA).

The FICA they would definitely extend the inflation adjustment to alternative minimum tax that's a 130 billion that's definitely going to extend it so the rates won't go up. (Doris Brooks: In other words they're going to keep the benefit). Across the board here this is all possible cases below 250 thousand will be extended that's a 155 billion, nobody is suggesting raising taxes from below 250. The ones all over the place are the sequestration it depends on some mostly repeals, some repeal, some implement, so that's how we end up with all these different cases with about the same results. The defense spending mostly repeal, nobody wants to reduce defense spending, now of course the problem with that is dealing the deficit and debt problem in a bit because that's wonderful to say it's okay we won't raise taxes but what are we going to do about the debt; are we ever going to get the debt under control, are we ever going to live on our income. (Gerard Cruz: How do you reduce deduction, tax deduction.) We will get to that, because I've got some numbers on that too and these numbers are really big. Home mortgage interest and property tax is 581 billion employer health care taxes. (Doris Brooks: But is that below 250 or above 250.) That's everything, that's everybody (Gerard Cruz: There was a comment where they were just going to give you one fixed total deduction and what that

number is, is what everybody just kind of gets). The problem with that is the lobbyist because everybody wants a pie for them and the problem is the way congress works everybody gets a pie and that's how we ended up in this mess, everybody has their lobbyist everybody makes campaign contribution and the reality is all this money benefits somebody; If you try to cut the property tax and home interest deduction the realtors which are very noisy are all over the place.

I mean everybody have some skin in this game that's why it's so difficult to do it, that's why it's called a grand bargain, it's going to make everybody mad, if everybody isn't mad there is something wrong with the deal; that's the only way going to happen if everybody's mad about it. (Doris Brooks: Everybody's got to give a little bit, we know that's does not happen in Guam, we don't give a little, we take a lot); everybody's going to give a little bit and that's what is going to be hard; (Gerry: what a concept) continuing on here we'll get to the grand bargain and how big some of these numbers are, give you a sense of how difficult it's going to fix that.

The Market does two things: (1) it measures what the present is and also discounts the future. You can look at the pricing of the market and if back out what it's forecasting in terms of things like real earnings growth for corporations. The market right now is all time high is likely we're going to see them fall its discounting long term earnings growth. The lowest it's been in a hundred years, (Doris Brooks: Say that again.) the forecasted future earnings growth it's in the market, remember if you are in the all time high the likelihood is it's going down (Doris Brooks: Sure, but that far down, the lowest in a hundred years) it's been low in 1917, 1950, 1975, and 1981 that's when it's been the kind of debt that we're heading for. Bond yields are at the lowest it's been in 110 years and there half the levels of the late 1940's which was the previous lows in the last 110 years, (Gerard Cruz: nobody is complaining about their mortgage rate right now) well the people living on a fixed income are kind of unhappy. (Gerard Cruz: they should refinance their mortgage?) What are you paying on savings nowadays? (Gerard Cruz: we're paying better than the Feds) (Brooks: half a percent or less) (Gerard Cruz: 75 basis points.) (Rosalie Bordallo: yesterday, I went to the bank and TCD for 5 years, 1%) (Dr. LG: you're lucky you have money) (James Duenas: you must have no debt if you're willing to putting money in a TCD)

Let's talk a little bit about this debt issues, so called Grand bargain there was a super committee put together the Simpson Bowls committee they basically came up with a plan. The plan was a good plan because everybody was mad about it. It basically, it raise taxes, cut entitlements was balanced and that should have made a lot of sense which meant of course it had no chance of success. There's going to be a significant spending cuts in significant tax increases well down into the middle class because remember we saw the imbalance well there is many fewer people in the over 250 thousand adjusted gross income. There is a big pyramid if you want to get to where the money is the money is in the fat part of the pyramid so we are going to see tax increases well down in the middle class. Individual tax deduction the likely targets in a grand bargain scenario give you a sense of the money we're talking about (Doris Brooks: which one?) employer health care 750 billion a year. (Doris Brooks: the deduction) Yes, the government likes to call tax expenditure because the

government believes all money belongs to them and they only let you keep a little of it, so they call it deductions and tax expenditure because they're allowing you to keep some of your own money government at work.

Home mortgage interest property tax deduction 581 billion, reduce capital gain dividends tax 456 billion, deduction for 401K contribution 376 billion, earned income credit people who are making just slightly above minimum wage get 294 billion, deduction for contribution to the defined benefit plan 264 billion, charitable tax deduction 186 billion. So, remember the debt is up to about 16 trillion, so if you're going to reduce that or just keep it from going up we're on our fourth year incidentally of a trillion dollar or more fiscal deficit, to have the deficit you're talking about 500 billion dollars so you can start looking at the shopping list (Gerard Cruz: we have some money coming back) it's so-called the peace dividend don't spend it all. This is a huge issue going forward because the debt to get back to the academic studies Rhinehart Rolgoff, but the reality is that it is cutting into growth now if you think about how cheap treasury rates are if you go back to historical treasury yields were instead of the government being able to borrow for 10 years at 1.7% its paying 6% and instead of 30 years being 2½, it's more like 7½ the interest clause will wipe out the discretionary federal budget.

There will be no money for anything if you leave defense and you leave entitlements and you leave debt service there is no money. There's no space program, there's no post office. (Doris Brooks: there's no Sesame Street – poor big bird is gone) and what's happened is the government of course is trying desperately to reduce the deficit and one way you reduce the deficit is you shorten the duration of the bonds you issue the maturity of the bonds you issued. So we're previously the government had a mixture they will sale 30 year bonds, they will sale 20 year bonds, 15 year bond they basically been selling short bonds.

So the reality is when rates rise it's going to feel, the government is going to feel this increase in debt service cost very fast. (Doris Brooks: say that again, are rates really projected to rise) they will rise at some point (Doris Brooks: but right now) no, but the reality is again you have to plan might not rise at 2015-2016, (Doris Brooks: okay) but when they do get back to historical levels they will simply consume the entire discretionary federal budget there will be no money for anything else. The deficit has gone up more than 4 trillion dollars in the last 4 years so we were at 12 trillion four years ago now we are at 16 trillion which is about 100% of GDP. Were not at this point yet, but the danger that you got in countries like Spain and Italy is when the interest rates you pay and your debt is greater than your GDP growth, you'll go bankrupt because you can't pay the increment of the debt unless your economy is growing faster.

Right now we are okay our economy is growing at 1.8% probably the average cost of the federal debt is 1.2 something like that 1.1, because they sell a lot of short term debt because the interest rates are the lowest. Spain, Italy are hopeless. (Doris Brooks: what about on the taxpayer, what I haven't heard is things like cut to foreign aid, I always hear this, oh but that is so tiny, oh but that is so tiny, a penny here and

a penny there) your double latte in the morning every day of the year is going to cost you \$500 a year \$600, \$700 a year, but the reality is that some of these numbers are so big.

We are not even talking about actually having to pay off social security instead of sending people letters every year about how much you are going to get from social security, wait until it's not a letter wait until it's a check that is when the manure hits the ventilator. (Doris Brooks: say that again). If you participate in social security and social security administration send you a letter every year saying based on your earnings history and your age this is the benefit you're going to get and increasing number of people aren't going to get letters they're going to get checks. Remember there is no money in social security people talk about social security lock box we have all this money set aside they have pieces of paper in a file cabinet in the office in West Virginia that's the money they have. All they have is IOU's from the federal government and does not change the debt but it changes the cash flow.

(Doris Brooks: and that social security is projected to increase even more because as we baby boomers retire) the debt won't change because the actuaries just like with your plan, the actuaries figure that once you start paying the cash goes out but the accrued liability goes down. The problem is you don't have to pay interest on the accrued liability, you do have to pay interest on the money you have to borrow to write the checks. So while it doesn't have an effect on the debt it has a huge effect on the cash flow because if we're borrowing a trillion dollars a year to finance operation and now we're paying out more we're converting this accrued liability to actual checks.

Just think about what happened to this plan. When I started working with you, what was your payroll? Couple a million dollars a year, 4 or 5 million a year. (Paula Blas: a lot higher) now, it's at 13 or something like that (Rosalie Bordallo: are you talking a month) (Doris Brooks: you're talking about the annuity) (Paula Blas: it was about 8 or 9 a month in 2003) I must have been thinking monthly (Doris Brooks: I thought it's closer to 160 million) (Paula Blas: we're just talking monthly it's now at 180 million a year) what's happening your liabilities been converted to cash flow. If you have a deficit and no money, like social security and then you got Medicare and Medicaid and all these other programs that is how you end up with 150%-175% of GDP total debt and the problem with this is we'll just issue more bonds some point people are going to stop taking the bonds or stop taking the cheap interest rates. Once the baby boomer start retiring they're going to get money for about 30 years unless you stop it or they all die, you're going to keep paying. That's a problem with that they're going to have to deal with it. Let's turn to Europe, we're done with the present part. (Doris Brooks: I am going to bet that even after the election doesn't matter who, that we continue to kick this can further down, we're going to tweak a little bit here and there, (Gerard Cruz: we're going to grow ourselves out of this.) (Doris Brooks: that's about it, leave a little faith, for Guam it's here because, unless this resolution on the income tax is resolved that's right now because we owe for 2012, 2011 and the budget is) (Gerard Cruz: we owe for 2011) (Brooks: still about 30 million) (Paula Blas: I thought they were already were paying that out and it's down



to 14) (Doris Brooks: it's still owed and there's no money for 2012 and people are going to start filing in January and that's what's going to push Gov Guam).

If we just talk about wealth if you have a 15 trillion dollars GDP, at GDP growth at 2% a year you are adding 300 hundred billion dollars a year to national wealth. If your deficit is a trillion dollars a year you're going to have to increase GDP not to 3% or 4% but to 7%. We haven't seen 7% GDP for 2 quarters in a row, in my memory. So we're spending money at a rate no amount of growth can fix no credit or amount of growth, we have to become China to have the national wealth created by growth in GDP exceed the level of deficits we're building. The only reason we are not bankrupt now is we're reserved currency otherwise nobody take our stuff now, I mean the Chinese are unhappy about it, but realistically because we are the world's reserved currency we get to force everybody else to eat our problems.

But, just to put numbers on this, our web national wealth is only growing at about 300 billion dollars a year 2% of the GDP addition increment to the wealth is peanuts. Having dealt with the decent part, let's get to the really grim part (Doris Brooks: every time you talk it gets worse and worse, we are gloomy and gloomier, where's the hope?) I'm not called Dr. Doom for nothing, I mean all I do, (Doris Brooks: I'm just joking, I like the reality check) I would love to be able to say everything is coming up roses but the reality is you have to look at the numbers. (Dr. LG: Instead grow eggplants, not roses.)

Let's talk about Europe in a short term we have seen a lot of positive political statement from European leaders the problems are over everything is great that does not square with the truth. Let's take a look at the Europeans what they're going to do, consolidated banking regulations very much desired by France they thought they would start by 2013 it's been put off. Growth in the European stability mechanism the 500 billion euro program to give money to the weaker countries for that to grow they've got to get specific bondi stock approval because they'll have the effect increasing Germany's liability above 190 trillion euros. There's no clarity on more bail out for Greece although some news report today from European paper that I was reading that they may have an agreement if Greece continues the program of austerity to extend the deadlines by two years. The aid for Spanish banks another seeming promises actually turn out to be less clear there's no actual plan just a bunch of words. (Doris Brooks: What austerity program did Greece actually implemented?) They haven't done much of anything, really (Doris Brooks: I just wanted to make sure) and having done nothing they've got 25% of unemployment, 55% youth unemployment, the stock market lost 80% of its value and haven't actually started anything yet. (Doris Brooks: are people still living there?) (Gerard Cruz: a lot of those Southern Europeans there moving to Hong Kong, even Hong Kong tons of tons of French kids) so far the ECB has lend 1½ trillion Euros (Doris Brooks: to who?) to various European countries and banks. The debt that needs to be rolled over and more money to finance further deficits is 9.5 trillion euros. So, I mean basically there is another drop in the bucket all that they've been able to lend is 18% of what the need is but they've now got is this kind of evil interplay where bankrupt banks are supporting bankrupt governments and vice versa.

The biggest danger really is the Spanish banking system which is a complete mess the foreign deposits are leaving once the domestic deposits start to leave the collapses virtually certain because there is no private sectors financing anymore. Private sectors will not give these places any money. The banks have been needing withdrawals by borrowing from the ECB and deleveraging in the 2<sup>nd</sup> quarter private sector withdrawals are running at 60% of GDP from the Spanish banking system an annualized basis. There running out of collateral because to borrow you got to post collateral no more collateral that's any good. Part of what the ECB is now doing is taking government bonds as collateral because they don't have any other decent, so their taking worthless bonds basically to make loans.

Portugal and Greece made little progress on competitive issues wage at a unit labor cost basis wages in Greece are 40% higher than Germany and Portugal is 30% higher than Germany. (Doris Brooks: say that again) if you look at wages at a unit labor cost basis how many dollars or euros you spend to produce a unit of output (Doris Brooks: okay) the wage cost increase are 40% higher so that's how much wages have to fall in Germany.

I mean that's the central problem with the Euros zone that they got this economies that's completely different having a common monitoring policy and common interest rate policy and that's why you can't make this work and of course you end up with the question that the German's faces are horrible ending worse than a horse without end. For those of you who are interested in this, in the UK an individual named Lord Wilson sponsored a prize in 2012 the Wilson economic prize and people competed to win it the 1<sup>st</sup> prize was a 250,000 pounds this wasn't a trivial thing. (Doris Brooks: that's real money) that's real money and there's a website (Doris Brooks: what's the website?) I will have to send you the link.

They posted the (5) five finalist and one of the five finalist was written by an individual Neil Record and he's got a company called Record Currency Management they came to visit us and got a copy of it I never heard of this thing and you read this. First of all, don't start it unless you are prepared to finish it, because it's completely gripping it reads like a cold war era nuclear war finding strategy. It is what to do to get out of the euro (Gerard Cruz: to get out of the euro) and it's immensely complicated because you got all these contracts that were written if you got a mortgage in euros issued by a Spanish bank and you live in the Czech republic, what do you pay them back with?

All this foreign exchange contracts that are technically stateless and one indication, because they're in the currency management business, one of the things that indicates that's unraveling is where previously people use to do foreign currency contracts I'll give you so many euros six months from now in exchange for so many pounds sterling today. They're now writing contracts that aren't in Euros there in the legal tender in Germany at the expiration of a contract. They have a contract which of the euro is gone you don't have, what do I do now. You're starting to see people write foreign exchange contracts where the currency that you pay back is

called legal tender contract. They don't specify the euro and say whatever Germany is using the expiration of contract that's what you get payback in. And that's basically, (Doris Brooks: and they're using Germany as the) well, the Germany is the strongest one and in fact I have heard of this antidote and I will send you the link, send it probably to Diana so she could distribute the link to both the five finalist and this one from Neil Record. He talks about euro notes if you look at the euro note and you look at the first character of the serial number you can tell what country issued the note. The Euro notes are not issued by the Europeans Central Bank there issued by the National Central Banks (Gerard Cruz: of each country) of each country under the control of the Europeans they just can't print as much as they want, but you are now starting to see people who won't take Euro notes that have certain letters in them X's in them are Germany so if you got any Euros notes with an "X" in the front that's the good girl note.

He talks about and I'll tell you it is absolutely gripping and it sounds just like a nuclear war fare strategy (Doris Brooks: it sounds like a novel) it sounds like a novel but except it's very real he makes several points. (Doris Brooks: no, a horror story). One of the points he makes is as soon as one country leaves it collapses you can't just say well let's just let Greece go and then we will all be fine. And he talks about the mechanism for that, because part of the way the Euro works is the assumption that it won't break up as soon the first domino falls what happens is the spread of interest rates becomes unsustainably large. (Doris Brooks: So, Britain is happy that their not part of the Euro) oh yes. We'll talk about a little bit about Britain potentially leaving the European Union which is if you read the British papers, which I read three of them every day, you get a sense that this is likely there now going to opt out of 158 different European regulations. They've negotiated and opt out about 5 years ago and their basically saying we're not going to participate in these. The Coltish government particularly of course a conservative in the Coltish government have said we're going to have a referendum about leaving European union they're not part of the Euro but they literally leave the European Union. Because what's happening (Doris Brooks: But what is the European Union?) The problem is that if you're a member of the European basically you no longer really make your own laws anymore.

The basically Brussels can say well you can't make that law or that law is unenforceable. (Doris Brooks: to oppose it on other countries) yes, the approximate cause of this is something call the European arrest warrant that basically anybody in a European country can already police force in a European country can get a European arrest warrant and arrest a foreign citizen and bring them over, and it was originally you know, terrorists, now it has become parking tickets. You can be subject to European arrest warrant if you got an unpaid parking ticket in Paris. So it's gotten completely crazy they had some sort of crimes against humanity has been now sort of scaled down in some minds to the crimes of Euro skepticism. If you think the European Union is a bad idea, you are a criminal. (Gerard Cruz: really, there's a law) yes, yes. (Doris Brooks: what, you've got to be joking?) No.

These things are very loosely written and they become interpreted by bureaucrats and the bureaucrats are taking the looseness of the language and expanding it grotesquely beyond what was intended. The Finns are probably going to leave because they join and thought this was a great idea all they have been doing is writing checks to people who don't want to work so they about had it, but the interesting thing about this paper that you'll read is how difficult it is to make the thing go away. His argument is Germany will leave, in fact, if you look at (Doris Brooks: and once Germany leaves everybody goes to pot) well, what you have is about half the countries now are debtors who want money and the minimum Greece, Spain, Italy, Portugal, Cypress, France is probably not that far off and a diminishing number of people who are going to pay you know, the Germans, the Dutch, the Finns, (Doris Brooks: the Swiss) no, Swiss aren't in it the Austrians, maybe the Belgian are pretty in bad shape themselves, so what's happening is where it use to be just 15 or 16 Euros own countries bailing out Greece now half of them need money including Italy and Spain which are much to large to rescue.

The two possibilities are the ECB runs a monetary policy to the debtors country liking which is intolerable to the creditor countries, Germany, or the European central bank runs a monetary policy acceptable to the creditor countries but intolerable to the debtor countries running huge austerity programs. The logical result is that the creditor countries leave began the argument of horrible ending is better than horse without end. The trouble with the monitoring policy at the ECB the Germans have put up 27% of the capital there on the hook for 27% of the liabilities and they get one vote and if somebody once observed that taxing Peter to pay Paul is sure to get Paul's vote. So the reality is the German's who have consistently voted against a lot of these bail out programs or they just get out voted.

(Gerard Cruz: why not just leave them) well, it will cost them a lot of money because I've seen estimates 17 trillion Euros the cost to break it some of these numbers are inflated to make them as horrible sounding as possible their big exporters if nobody has money to buy there stuff remember there big market is the countries around them and if the countries around them can't afford to buy their stuff export markets aren't worth very much. So it truly is a question are they simply going to kick the can on the road and off course the Germans who are the ones providing the can it is the classic example.

What's another couple hundred million euros, couple hundred billion euros, couple billions pretty soon we're talking enormous amount of money and of course then the argument is going to be if we could spend a little bit of more money we all had this experience a little bit more money we'll be okay, we will get some more money back never get the money back. Some point the people are going to say well we're not going to put good money up for bat so that's what happens. (Doris Brooks: So, is China to the rescue).

The Chinese are much too clever to get involve with us, they're not fools they've been in business for four thousand years they've seen this kind of stuff before. Another problem that these debtor countries have is when they did the restructuring the debt

in Greece the private sector took all the losses. The IMF won't take losses, the ECB won't take losses, the National Governments won't take losses through the Central Bank, Germany's on the hook for about 750 billion Euros through this target two program basically it's a mechanism they have just a bookkeeping mechanism to balance cash flow and money flows between central banks well they're on the hook for 27% of that and the reality is that there's nobody left to screw. There's no more private debt to stick with all these losses.

The next loss is going to be government, the German government, the French government, the European central bank. Well, it's easy to say to the private sector lenders to Greece we're really sorry but we are going to give you 20 cents to a dollar. We want the Greeks to have sometime you get 20 cents to a dollar we get paid dollar for dollar, however.

There no more private sectors lenders. So the next time one of these places gets in trouble it's going to be the government and of course all the politicians have told their people, don't worry we're not going to lose a dime it's not going to cost you anything to do all of this, it's all free. At some point if the Greeks default or the Spanish default or the Italians default or having all of them to default. The reality is the German tax payers are going to have to write a humongous check and that's really one of the limiting factors of how crazy this can get is the fact there's no more private sector debt to screw.

Because they've wiped out the private sector debt holders only governments are left and the government won't take lawsuit (Gerard Cruz: how long before that thing comes to and end) if you can run the printing press you can hold things off for awhile, that's what they're doing. A good analysis of deleveraging strategies that deals with releveraging. First you have transfers the rich give to the poor and that goes on for awhile and then you have austerity because there has to be and internal devaluation. If your labor cost 40% above your competition you got to cut wage cost 40% to become competitive again.

The standard line is after they try all this strategy they print money at the end they always print money. Well what you got is a major player in this process that has a cultural anathema to printing money. The Germans a very few Germans obviously can remember the rudeness inflation Via Mar Republican in 1923 the reality is you have to be almost 100 years old to remember that. It's a cultural memory it is very important and if it looks like all of a sudden rather there on a hook for trillions or they going to see there currency loose its value they're really going to be unhappy. So it only works as long nobody ever actually has to pay the bill as soon as somebody actually has to pay the bill the fun will be over.

(Doris Brooks: How did Spain get there?) Spain got there the way, I've probably use this line before, but it almost works perfectly. The countries who are in trouble are all wine drinking countries and the strong countries are all beer drinking countries and it works perfectly. The Austrians the Germans, the Dutch, the Finns their all beer drinkers the one that's questionable is Belgian. Belgian is more of a beer drinking

country but it got some difficult financial issues and it's had difficult financial issues basically since World War I. It also has no government it just not helpful but at some point you just can't keep the party going there's difference in the productivity simply is unfixable.

Next topic is there a long term for Europe and of course there is a long term for Europe geographically entity. But, I think this structural inconsistency in the market is just going to make it very difficult for the Euro to survive because it's going to reduce growth to nearly zero. It's the Euro, it's the greatest weapon of mass financial destruction ever invented and it is bankrupting entire countries. Because they can't have a devaluation to restore their productivity I mean if Greece still use the drop they simply would reduce the value of the drop by 40% and they have dozens of devaluation through the years and instantaneously there competitive because there local wages are paid if the drop falls 40% versus the Dutch mark there perfectly competitive.

The problem is they can't devalue so that's where this phrase internal devaluation comes from so they can't devalue there currency because there locked into the Euro. They have to cut wages 40%, they have to cut government spending 40% and they have to cut standard of living 40%. How did they get there, well the government doesn't collect taxes; taxes are seen being optional in a lot of these countries, they have very rigid labor laws which means that nobody wants to hire anybody because you cant get rid of them, there's such a thing as a business cycle and if you cant get rid of somebody when there is surplus and then hire them back when you need them if you have to keep them while you are not making any money to pay them you don't hire anybody.

(Doris Brooks: Is that both in the private too or is it only in the government) private sector too, almost impossible to fire somebody in any of these countries. (Brooks: really, in the private) the private sector (Doris Brooks: we don't fire people in GovGuam). So, the reality you've got preposterous benefit programs the Greeks can retire at 50 unless you're in a strenuous occupation which includes things like hairdressers. (Doris Brooks: we use to allow employees retire at 40, with 20 years) The nice thing about accounting, at least three of the people in this room are CPA so we could relate to this. The best thing about accounting eventually the books have to balance you can't pay pensions unless there's somebody making money to pay them and you run into to this term that you call support ratio which is the proportion of people who are working relative to the proportion who are retired, but social security was set up in the U.S. in 1938, there were hundred workers for every social security retirement 2½, 3 to 1. One of the European countries will be 1 to 1 by the 2020.

So, the reality is you just can't pay people if nobody is creating wealth to pay them otherwise you are effectively confiscating the entire wealth of the younger generation. So, you all young ones you keep working so I can get my pension, (James Duenas: I'm 4 to 1, I got a chance) (Paula: No you have to share yours). Japan, I know it's important here the Japanese growth is stagnating at weak levels. Exports are

negatively impacted because of the end is fairly strong. The trade deficit is near 30 year high there importing more than there exporting that's has change obviously since the 1950's when the Euro exporting nation. There soft domestic demand. The emerging marketing continued to be vulnerable Chinese slow down 34% in emerging GDP is exported to Europe. So if Europe has a recession going to be very negative in the emerging markets. China the GDP growth is little over 6 but by their standards is pretty low.

One of the things is worrisome this leadership transition is getting very messy. His name Bo Lee Xi Chilei this is the guy who was supposedly one of the leaders now is under arrest his wife been convicted of murder it's a comedy American reality TV show. This is getting messy because his leadership meeting is going take place the people party congress is going to meet two weeks after our elections and vote in a new central committee which votes in new Poleat bureau in a new leadership. And the reality is a lot of the leftist now are protesting that Mr. Bo is basically been effectively deposed they've never had a leadership struggle in the sort of big country, major economic power, major military power era and this is starting to get a little messy.

They've also have economic issues there slow downs across all sectors, production investment demand, housing import exports are all falling, industrial production is down 6%, fixed assets investment down 17%, retail sales down 3%, export growth down 11%, import growth down 9%. The import growth is important for counties like Canada and Australia because China is the single largest consumer of industrial metals they've use 44% of the industrial metals in world.

They been easing economic policy but the reality is that there now struggling to reinvigorate their economy they probably need 8% growth or some number like that to reduce the social strength. They now have people in the Shenzen especially economic zones working short hours or have their company failed and they just lock the doors so things are getting difficult in China and have very little experience with managing this kind of economically induce social stress there's some risk there. Realistically equities are probably going to return mid-single digits numbers for the first year of the future, single digits 4, 5, 6% that's what the forward looking sense is from the pricing of the market.

Looking at the impact of global GDP I'm talking about globally not the U.S. and if you are looking at maybe 5½ or 6% real you're probably looking at maybe 7% at a adnominal basis for equities and more like 3% or 4% for bonds it's going to be very difficult to produce the kinds of returns that lots of investors feel they need to produce. So this global slowdown is just going to make things pretty miserable going forward again I would just point out U.S. we've got a long way to go to get back to a decent place.

Final notes, depressing growth, growing deficit, debt concerns everywhere, global crisis everywhere plus we've got Iran, Syria, North Korea, Middle East, across the middle east dangerous place dangerous world. (Doris Brooks: So, where should we

invest, that's the bottom line) (Chairman: but, where do we fit in, now) well, what it's going to do is it's likely to produce less growth going forward. Low interest rate when you look at the present value of future benefits causes the present value of those future benefits to be relatively high. If you're discounting the extreme of future benefits at a low interest rate it becomes nearly the sum of future benefits. So funding levels are negatively impacted you got sort of the perfect storm funding levels fall because liabilities rise with low interest rates and expected returns from pretty much any investment are poor it's not the same and we've seen it for year to date. (Chairman: Would it be sustainable?) Well, the question is, here's how long it's going to be. (Chairman: are we going to end up more of the negative). It's going to be very difficult because cost are rising and if expected returns for a typical asset mix aren't 7 1/2 or 8 there more like 6 to 6 1/2. Now it's not to say going to get good look at the year to date 16% year to date when we say that is likely stocks are going to return 5 1/2 to 6 % real, maybe 7 nominal that doesn't mean going to be 7 next year, 7 year after and 7 that is the long term. What you had is a fifty year certain a thirty year period extraordinary returns. I can almost tell you the day it started in 1982 when the prime rate was 17%. T- Bills were yielding 50% and the Fed said we're going to put a stop to this and you've had rates of a thirty year period fall from 15% to 10 basis points. That's not repeatable you've had the perfect environment you had the enormous productivity increases with technology you've had tremendous productivity increases as emerging countries like China started to produce products at much lower cost so your dollar went further.

You had interest rate constantly falling, you had more sophisticated management of the economy use of computers for doing economic modeling all of these blessings are not repeatable. We have interest rates fall from here to here well there not going to fall to the floor. Interest rates rise it hurts everything it hurts bonds they fall on value automatically it hurts stocks it probably connotes increasing inflation that's negative. So in a sense we've had all this wonderful stuff like the fiscal cliff, but you had is a goodness cliff we had all the goodness occur over this 30 year period. It's not repeatable and in reality it's not going to norm and that is going to reverse. We have long-term bond yields fall from 17 or 18 or 20% down to 3%. Well if the normal 7 we had all this benefit of the fall going to be painful when they go up even back to normal. So it is going to be tough. (Chairman: How is that going to affect our allocation?) In general you should diversify as much as you can. Let's get technical when we last work on your pension plan you had lots of different asset classes. If you look at those asset classes and some of the limitation are both legal in terms of what you can invest in and what the Board at the time felt comfortable investing in and dislikes for alternatives and dislikes for hedge funds the remaining regulations that allow you to invest in things. One issue with that is all of those asset classes although they had different labels had a high degree of commonality in the risk if you look at a pie chart and this not just true for your plan; is true for most plan if you had a pie chart or your own 401K or your own IRA. If you had a pie chart and you said okay I got so much in stocks, so much in bonds, so much in real estate, so much in hedge funds, so much in alternatives I look diversified.



But if instead of looking at the label what the thing is call you look at how it does behave. What are the fundamental risk factors that drive it? What you'll find is the typical portfolio will have 80% of its risks in one risk factor which is exposure to what's called equity risk premium. That's a problem because if equity risk premium declines basically equity risk premium it's the difference that the stocks return from what risk free rates return. Ordinarily you would expect to get paid extra for investing in something that's risky. If you could invest in government bonds and be sure you'll be paid back that's an interest rate here.

If you're going to invest in stocks where they go up and down the company might go bankrupt you want the premium for investing that premium is call equity risk premium. That's obviously very high when you own stocks but if you own high yield bonds it's pretty high there too because realistically if the company goes bankrupt you don't get paid and the stockholders don't get paid so that risk factor is highly correlated. So when you start to look at the risk factors in the portfolio you find that you think you're as diversified as you could be and again you got some limitations what you can diversify partly because the law won't allow it and partly because you don't feel comfortable with it.

The reality is where people are going now is much more diverse set of investments, commodities, currencies, emerging markets small cap, spread things around so that you're not exposed to so much concentrated risk but you got to be careful because you can say well we got this and it's label this and it's label that is label that there all different well there not they behave alike. If you have two different asset classes that sound different but they go up and down like this you only got one asset class.

So people are looking at very diverse investments tragedy so I got another large client that invests in a strategy from this company called Bridgewater that invest in 80 different things. Basically it's composite it's a fund that invest in 80 different asset classes because they want to diversify the risk. (Gerard Cruz: which one is it called) The Bridgewater Alpha program and the Bridgewater has (2) strategies they got an Alpha strategy that's trying to produce high returns and they got All Weather which what's called a risk parity strategy. We talk to you about risk parity strategy. Risk parity strategy you explicitly diversify to have the same amount of risk of stocks and bonds and commodities.

The problem with risk parities strategies is the risk of equities is say 18% a year and the risk of bonds is 4% a year, the only way to make those two risks equal is you got to have leverage. You have to invest four times the market exposures your capital in bonds so they both have the same degree of risks that's what risk parity means all the risks are equal. Well, there's historically been a concern. I mean leverage, bad but this case this is leverage not to trying to make money it's not going to the race track and investing in the horse that's lame because if they win you get paid a thousand to one it is to reduce the risk. (Gerard Cruz: so, would you change your entire portfolio or would you allocate a certain amount to a risk parity strategy).

I think the risk parity the whole way will probably be excessive and in part because of where interest rates are now. If you lever a fix income with rates as low as they are and rates rise you're going to get hosed I'm trying to find the right suitably politically correct language, I could think of some other words, but it would not be pleasant. (Gerard Cruz: is it there an explicit correlation in equities to if rates rise would equities be negatively be impacted) There all inter-connected and if you remember the Star Wars movie the force pervades all of these I mean there's nothing you can invest in that doesn't have some correlation, there are a few things I mean people ask is there something that we can invest in that's has no correlation with anything else and the only thing we could think of what are called catastrophe bonds. Catastrophe bonds are bonds that pay off in the event of natural disasters like hurricanes, earthquakes and the like. Well, the earthquakes, hurricanes and the like have no correlation with economic activity, they have no correlation with interest rates, they have no correlation with anything.

So, if you want a completely uncorrelated risk a perfectly diversified uncorrelated risk catastrophe bonds make a lot of sense. Now you couldn't put the whole portfolio in catastrophe but you don't put everything into anything but what you do is you start to moderate the volatility by having more and more uncorrelated assets. We'll talk a little technical here when you make an investment unless it's an index fund you're looking at two different types of behavior your looking at beta which is the return you get from simply investing in the asset class and Alpha which is the manager's ability to add value you want to have diversified beta so you don't want to have all your assets going up and down like this and if you can you like that diversified sources of Alpha which means that you have investments such that all your managers don't get it all right or all wrong at the same time this is not easy to do.

But the easier part of it is to have diversified sources of beta (Gerard Cruz: what's the trade of with investing or including a risk parity strategy, let's say we carved out 10%) I'm only talking theoretically (Gerard Cruz: right, of course, isn't there an earnings trade off in there somewhere) yes, it's like insurance you can't buy insurance for nothing, anytime you insure against a risk we've looked at tail-risk strategy what can you do to avoid the 40% loss, is there strategy that you could do that would avoid what happened in 2007 and 2008 when the equity markets were down 50%.

There are tail-risk strategy you could sell, put options and there are other strategies that you use derivatives (Gerard Cruz: But is that a strategy from this level of implementation or is that something that a manager does because of the situation) typically you would hire a manager (Gerard Cruz: what I'm saying is that from our stand point where we employ a strategy from a high risk level and then hire managers to execute, is that something that we would do or is that something that we would say; or a manager would do as a part of their execution) Typically you would hire a tail-risk manger you'd hire a manager who's is writing put options or using maximum diversified portfolios or some kind of technique to moderate risk. One of the techniques frankly is quality equities if you are concerned about an economic down term the kinds of stocks you own matter. You want to own stocks

that make products that people will buy even if times are tough. You want to make stocks you want to buy stocks with company with strong balance sheets that can survive a down term.

(Gerard Cruz: Wouldn't a long value type manager in a down term they foresee coming also be looking for companies like that) well, value is a funny thing (Gerard Cruz: I'm just talking domestic I'm just I guess what I'm saying like if we specialized our portfolio to that degree and taking a contrary view of what's coming in the market do we have to be almost actively engage when our view changes to say okay let's pull that manager out and trade it with somebody because now we're seeing a better picture of the economy going forward) That's an interesting question? One of the things that makes this difficult is if you run a continuous hedge, if you hedge tail-risk continuously it cost you a significant amount of term it's just like an insurance premium if you want to make sure you get paid when your house burns down you have to have insurance all the time. You can't buy insurance when your house is on fire and one of the problems with tail-risk is the nature of stock markets returns and you've seen this statistics if you are out of the market for 20 days in the last 20 years it reduces your equity return by half, so the ability to predict if you've been out of the market yesterday if you would have somehow you would have saved 3 or 4 percent. But when it reverses when it goes up 300 points in a day the S&P goes up 40 points in a day so the market typically doesn't do this its serious spikes. And the problem with being hedged is you have to be hedged all the time to run what's call a tactical hedge is very difficult.

Because risk is very well priced in the market if everybody thinks the market is going down the cost of insuring against the market going down gets very high it's just like hurricane insurance is very expensive in Florida I could get it if I wanted it for free. Earthquakes insurance cost me \$4,000.00 a year, in Florida you could get it for free. So in order to afford it you have to have it all the time and it's a constant drag probably 2 or 3 percent to protect yourself against the 30% loss or to make a 30% loss a 10% loss is going to cost you 2% a year.

So in the long run it's hard to do, tactical hedges are very hard to put on because when you know the market is going to go down unless you have some brainstorm, so does everybody else. In fact when we saw the Vicks become 60, 70, 80 and it was very, very expensive to buy protection we went to some of our bigger clients that don't have liquidity issues and said why don't you become an insurance company. If insurance is ridiculously costly relative to the actual risk be an insurance company book other peoples bets I mean these are all two way market. You can buy insurance or you can write insurance and it all depends on price, if the price is cheap you buy, if the price is expensive you sell now, it's not for everybody.

The problem with the protection, the tail-risk hedging, the maximum diversification strategy is they cost money just like any other insurance. (Gerard Cruz: that's what you use those strategy for purely insurance) Yeah, their basically not and you typically price them to protect you from a loss above 20% it's just like car insurance

if you want to get paid when you have a very small claim it's going to be very expensive.

(Gerard Cruz: the flip side though is that it limits your upside) Yeah. (Gerard Cruz: it has to.) I mean risk is very efficiently priced and unless you have some special unique knowledge which is impossible to have (Gerard Cruz: does it even do worse if the market is flat) yes because basically you're buying insurance typically you buy insurance to protect you from a loss rate of a 20% you take the first 20% like a deductible in a car insurance you will self insure for the first \$500.00 or \$1000.00 because the cost of getting in first dollar loss insurance is very high. (Gerard Cruz: so then what I'm hearing is that those kinds of strategy tail-risk hedging, risk parity work excellently in severe down markets but we pay the price in flat side-up major, it's a drag)

Basically if you're paying an insurance policy to protect you against losses more than 20%, if the market is flat down than 10% you're getting nothing you're just paying premium, paying premium. So the question is how damaging is a 30 or 40 percent loss most 30 or 40 percent losses have been made back relatively quickly I mean we saw a 50% loss peak to trough in 2007-2008 we're basically back to even, so the reality is you would have been paying for protection which you would need if you had to cash out. If you knew you were going to terminate the plan and cash out in the next 2 years and you couldn't take a loss by take 4 years to recover then you pay the premium. This is basically what somebody looking at retirement might do and if you're near retirement where you don't have time to make it back to recover.

If the market doesn't do this, but rather it does that, that's a different problem. Then it's not a question of protecting you against fluctuations it's protecting you of what's called a permanent loss of capital. What you had in 2007-2008 is not a permanent loss of capital you're back to where you were actually better where you were. (Gerard Cruz: we're better, we lost half of the market loss 2007-2008.)

When people looked at these strategies there's nothing like focusing the mind of what we had in 2007-2008 everybody was looking at the tail-risk strategy we got papers on tail-risk strategies (Gerard Cruz: there's tons, so many new strategies and ways to tweak the models and do something and it always come back to just what has been tried and true to some degree going to have to make market changes but this new and improved strategies, I don't know)

Well I mean you get cynical there all trying to sell you something trying to sell you the latest and greatest thing and you know well this is something that's not an issue for Gerry but if you ask a barber you need a haircut what kind of answer are you going to get? (Gerard Cruz: the problem is if you have two barbers that's the worst you don't know which one to listen too)

Now the thing that's difficult is if we're talking about a secular change where money is not going to be as easy to make as it's been the last 50 years. The reality is been easy to make money the last 50 years we get a 10% return you double your money

every 6 years in 18 years you've got almost 10 times as much money you double, double it again, double it again.

So the reality is if instead of stocks returning 10 they return to 5. Now it's a lot harder to make money it takes longer to recover from big losses. We were amazingly fortunate to get the kind of recovery we did it's not justified by the fundamentals economics. You could call it another bubble it's basically a market insanity.

The fundamental economic do not really justify a 100% return which is what we basically got from troth peak. We were lucky and the people who are real looser are the ones that said I can't take this anymore and it became very conservative that's the classic model. They loose the money and then they give up. Now, they've given up any chance of getting it back because it's the market that gives it back to you.

But, if that market has change if were in the low growth environment because of debt because of demographics then frankly the demographics are the biggest problems and realistically if we had population growth the debts would be as much of an issue because you could grow out of it. (Brooks: oh, we can grow out of it.) Yes, if you had the population growth.

One way of thinking of GDP is growth and workforce times growth and productivity. But the reality is demographics are the biggest problem the debts bad, but if you had the demographics on your side which we don't. (Doris Brooks: even with all the migration we have) the problem is remember the old story if you want an oak tree you better plant 20 years in advance if you want to sit under an oak tree in the shade think 20 years event. Unfortunately all the workers that are going to be available to work in the world 20 years from now are alive today. We're not seeing some of this stuffs is kind of obvious when you think about it this is not Star Wars were you've got the clone army, that's not real.

So the reality is were kind of now locked into a track driven by the debt, driven by the demographics it's going to be a lot harder to make money. (Wilfred Aflague: is this the new normal that you mentioned about 3 years ago) Yes, this is Pimco's new normal basically the normal is going to be lower growth probably more or the same level of volatility; less growth doesn't mean less volatility but it's going to take longer to recover but that's what Pimco talks about when they talk about the new normal it is not a cyclical thing it's a secular change.

(Wilfred Aflague: So, do we adjust our expectations or do we diversify our portfolio) it would be wise to adjust your expectations. (Gerry: just can't put that into mathematical formula because it makes our contribution rate go up) yes (Chairman: we can't afford it) (Paula: yes, because you can only get what the market is going to give you) (Chairman: you have to be cautious because it will be disastrous) (Wilfred Aflague: I got it) (Brooks: are you retiring?) (Wilfred Aflague: No, because my wife doesn't want me to yet, but I decided the best job to have on this island right now, pay all my bills and be the checker in front of K-mart you know when people go out, no stress at all, but thank you, I'm understanding this new normal concept because I

heard you say this about 2-3 years ago how weak it is now) yeah, this is where we are. And not to, this is not whimsical it's not futuristic, but it is an interesting comment. We had a client conference 2 weeks ago in St. Louis for a not for profit like endowment foundation health care and I was talking to somebody from a University Endowment in Texas.

Now this is not the whole population but he said everybody he knows has a bunker (Gerard Cruz: everybody he knows has a bunker) yes (Paula Blas: they're preparing) (Chairman: are we prepared?) (Gerard Cruz: for what) social disorder. Now this is not everybody this is everybody he knows. So, we're talking about a particular stratum of the population and this is Texas (Paula: and they even said people in Utah are doing the same thing, they're actually storing food) well, the Mormon, the latter day saints church has always emphasize this kind of thing (Paula Blas: they're already seeing the social issues that are going to happen, there's going to be shortage on food) (Rosalie Bordallo: I better start getting those chickens that are running in my yard. (Paula Blas: that's why I said farming, you need to start farming.) (Doris Brooks: I remember my dad said twenty years you've been feeding those chickens and I never ate one of them, they were pets.) (Dr. Leon Guerrero: adjust your expectations).

Should we talk a little about the 401K plan, (Chairman: I think this is better, because how are going to monitor it) (Paula Blas: these are individuals) (Chairman: yeah, but the fact that there will be a certain growth) (Doris Brooks: but, Terry you're not doing the DB Plan anymore, you're only doing the DC) right, I'm only talking conceptionally, this is not investment advice, I'm teaching. (Paula Blas: but what he's saying is that it's not any different from what our consultant is saying, also) (Brooks: yeah, it is different the environment, the new normal) the new normal (Doris Brooks: where you also said cash is king).

It's going to be different because nobody who grew up in the Post World War II period has ever seen anything like this if you're my age our parents did, the depression. (Brooks: lucky the people of Guam didn't do that, we weren't a part of that) (Rosalie: the depression wasn't the same thing here) (Paula: we just had a war) (Brooks: yeah, ours was a war, that's true).

### **DC Plan Performance**

So, let's take a look at the 401K Plan look under tab 2, page 10, some of this is of course for the benefits of the minutes here speaking to the minutes because you want to evidence due-diligence and good fiduciary behavior.

Page 10, we've seen this of course many times looking at the funds that you provide because it's your responsibility to provide funds that are distinct to allow people to diversify and to construct portfolios that are suited for their own unique risk in their term requirements. Basically you got something in every useful bucket you don't need to populate every one of these. Again would point out that the International Bonds which you have is not a common option I think it's a great diversifier. (Doris Brooks: which one?) International bonds, the Spanish Mail International fix. That's a

really good diversifier because it's basically other people's interest rate structure, its other people's currency structure, and its other people's security specific risk structures. It also occupies the nice space if you look between market duration bonds and large cap values there's kind of a big blank space and you have something there which is better than most people have. (Gerard Cruz: that's why we put it there, we saw a gap).

If we turn to page 11, obviously we had our up quarter. We saw increases in both the 401A and 457 plan about proportional. These net of course of edition of withdrawals give you some sense of what the returns are for the participant base. Again, the equities were up about 6% so pretty decent returns because you do have high allocation to the target date funds.

Some plan comments, basically were not recommending any changes to the plan as we mentioned before we're becoming increasingly anxious about Franklin your small-mid manager. I would say that when I am back in January if we haven't seen better result through your end it's very strange market it's hard to make an assessment I think we're going to recommend a change there. Because I think that realistically they've been under performing for a number of different market environments it's very difficult in any particular market environment to say somebody's good or bad. They might be in favor or out of favor but their not bad it is just what their doing is in favor or not in favor. But this is been a period of time when we see market down, market growth, market value, large market, and small markets. So, I think there probably we're going to recommend replacing them. Generally the funds have done relatively well there are comments here about all of them.

There are some news items the one that continues to do really very well is the DFA emerging markets there a news item here about DFA emerging market their assets side is very large but we are really not expressing a concern.

On page 16, there's notes about Black Rock, Black Rock is having just continuing management changes it does because of there in passive index funds it really does not affect you that much If you a member you absorbed BGI and every time one big company acquires another big company there's a lot of shuffling of desks in the light. There are some notes about Chaplain that is your small cap managers, their performance has not been great, but we still like their strategy.

There is a lengthy note about DFA some concerns expressed about there long term corporate direction but that fund has been performing very well and in general we still like them. DFA is a funny manager they don't have analysts, they don't really buy things they think are going to go up and sale things that think are going to go down.

They don't do research actually what they do is hold a much diversified portfolio. Primarily small stocks, small cap stocks, and value stocks there is an effect that was found academically in the 1980's that said there is a positive tilt or a positive advantage to investing in small and value stocks it was developed by Jean Fama and

Ken French both noble prize winners who have been very thoughtful thinkers about the market. So, you sometimes hear Fama-French basically Fama-French said; there is a persistent advantage to investing in small cap value stocks and DFA basically invest in a very broad range in small cap value stocks. They also have an interesting trading strategy they own thousands of stocks in the portfolio and they make money in part by being a buyer when everybody is a seller and a seller when everybody is a buyer.

Since their agnostic they don't care if they own a stock or not, if somebody says I am absolutely positively got to have the stock and I'll pay up to buy it, they'll sell it to you. If they absolutely positively hate the stock and want to get out of it right now, they're a buyer. So they make money in effect by arbitraging people who have intense feelings about stocks. So, they're effective proprietors of liquidity and the advantage is because is a very large portfolio they're not very voluble. They make nickels and dimes but they make nickels and dimes everyday. They don't have big winners, they don't have big losers.

The comment about Standish which is again one of your managers does not concern the strategy that you're invested in. Vanguard there is a lengthy discussion in here about Vanguard is a kind of a funny thing not for the Vanguard S&P 500 Index Fund you are invested in. But for the International Funds they have changed the Index against which they managed the hedge funds.

From what's called MSCI-Morgan Stanley Capital International to Index created by a part actually of the University Chicago Business School called the Center for Research in Security Prices usually pronounce CRISP and their building a customize Index for Vanguard and the reason is interesting it's all about money, if you are an Index provider like S&P, Russel and MSCI and somebody wants to run an Index Fund they have to pay you a license fee to use their data and their name.

So for example Vanguard pays S&P 500 a license fee to run S&P 500 Index Fund which you provide to your participants. That fee is pretty expensive and in the context of a very, very inexpensively run Index Fund it was causing the Index Fund to become expensive and remember Vanguard is a co-op it's not for a profit company. It's owned by the share holders it's owned by the people who invested in their funds. So there's no profits in Vanguard it's not a for profit company, all the profits get plowed back into the funds. The company pays dividends to the funds that their investors invested.

So there a very low cost provider they're the Wal Mart of the investment business their always looking for the cheapest price. So they said there's really no difference between these Index providers, but MSCI is charging us a lot of money for really nothing and we can provide a cheaper alternative that is just as good let's go with the cheaper alternative and save our participants money. This cost a huge flurry in the last 2 weeks this massive amount of discussion in the industry. MSCI stock lost 30% of its value when this was announced. (Gerard Cruz: 30%, wow.) 30 % because Vanguard paid them a lot of money and now there not going to pay them anymore.



But also I think it put pressure on a (Doris Brooks: primary customer, risk concentration) their primary customer said you are too expensive so we are going to go to a cheaper source just as good.

So, we might see more of these where people are beginning to become annoyed with what these Index providers are charging to license the names for there Index. Now this does not affect you it's still an S&P 500 Index Fund but a lot of their Non-U.S. and some of their U.S. Funds are now being bench mark against this CRISP Index. Again, we think this is fine it saves our participants money because the participants ultimately were paying these fees, now they don't have to pay.

In terms of asset allocations on page 20, 21, 22, 23, 24, 25, there's very little change basically quarter to quarter on the tenths. The one thing that is interesting and I don't know, I think it's a combination of people continuing to get the good education or maybe seeing that the market's been good because participant future returns.

On page 25, we saw a little bit more significant decline in the concentration in a 457 Plan and stable value and an almost 1% increase in the target date funds. We think that's healthy because stable value while has been a good performer in the low interest rate environment for fixed assets it's obviously returning just about inflation. If you invest your entire career in the stable value fund when you retire you'll have more money but the same purchasing power. You won't have gained any purchasing power because basically it returns inflation rate. So, this is again the 457 presumably the more sophisticated portion of the population base who are making additional supplementary contributions. (Gerard Cruz: tell Rosie).

Page 26, looking at the expense ratios again you got very minimal expense ratios most of your numbers are attractive there green in some cases hugely green, particularly because the maximum funds and for analysis benefit we do have a footnote here that indicate there are no expense ratios until 10 years maturity. That's why the funds from 20-25 on do not have any expense ratio's at all.

The three big negatives they're more expensive are Baron and Champlain and Thornburg and all of them even with this relatively high expense ratios have been good performance. If you look at the compliance table on page 27, the life path funds on this basis there's a lot of red XX's down there when you look at the life path funds. Most of these differences from the bench mark are pretty minimal. Again, the way the rules work if you're 1 tenth of 1% behind the bench mark you know the bench mark goes up 20 you are up 19.9 you get an X, but the reality is if you actually look at the underline numbers there is nothing really there to be concerned about.

If you turn to page 25, and I will just draw your eye to Baron, Champlain and Thornburg the ones relatively, page 28 rather, sorry my fault, looking at page 28 the 3 funds I pointed out having above average fees is the Baron, Champlain and Thornburg have met the requirement out performance query for 3 years and 5 years for both Index and Universe.

(Antolina Leon Guerrero: so do you think that a separate values so we are paying performance) you're getting the performance (Doris Brooks: you're paying higher but you're getting the return) these are all net of fees. Index funds are all after fees so their doing this well even with higher fees so I wouldn't mind paying high fees if I get real strong returns.

Looking at the others again you could see the Franklin is got some issues. The Universe is only two quarters in the red X category the one that's really bad is the Index return for 4-5 years that's been on the naughty list for a long time. So, I think we're going to wait until we see what the post election for the fiscal cliff market environment, if their not better by the end of January when I am back will probably say good bye to them, Franklin Smith fund.

If you turn to page 29, looking at the performance summary. Galliard the stable value fund looks fine. Notice that the benchmark is T-Bills plus a 100 basis point. T-Bills are zero so the benchmark is effectively are almost zero, effectively is a 100 basis points. Because their in invested in what behaves like a 3 year yield with an upward slope yield curve they got a persistent yield advantage over this benchmark. The other thing is because the benchmark is all premiums there's no treasury bill yield, the differences are you just can't get to be super terrific because the benchmark is a little unrealistic.

Hartford the total return bond fund continues to do extremely well if you look at the one year return 7.9% for bonds is a pretty darn good return. The Black Rock inflation protected fund on a relative basis have been extraordinary first docile for a all the periods except the quarter lagging but generally lagging only by 10 or 20 basis points. Again the red numbers I've argued with our technical people that we ought to have what's call a fuzzy logic near. I would say red if it's 60<sup>th</sup> or worst; blue if it's 60 to 40; and green if it's 40 to zero. But I'm dealing with people who tend to like boundaries, I like fuzzy logic.

The Standish International Fix fund again this quarter it was a little weaker on the relative performance side, but solidly above the benchmark very strong returns across the board. The Secure Foundation ballots fund, you see couple of red numbers there but in one case is 10 basis points on a base of 440 and the other is 20 base points on a basis of a 1,020 so I wouldn't worry about it.

The Life Path Fund this comparison is good they continue to lag again their passively managed. So the actual components, the underline bonds, stocks, cash components are Index Funds and in the market where active management has been out performing a little there going to lag. And up markets, active management tends to do better than passive management, and down market passive management tends to do better it's just the way the markets work.

So, I am not concern again, if you look at these there typically a handful of basis points off. If you look at the 2050 fund for 9 months the Index is 14%, the Portfolio is 13-6 I wouldn't worry about that.

I did ask our people whether or not there a half decade funds for Black Rock it is 2012, a piece of inspirational thinking. It is 2012 it is rather far to 2020, so there is a point in the calendar when, if you have decade funds. (Doris Brooks: no it's not, it's only 8 years not a decade, that's two elections) If you have decades of funds 2020, 2030, 2040, 2050 and you're at this point in a calendar, 2020 is far enough out that you actually have a relatively high proportion of risk assets. I did ask do they have half decade funds because if you're going to retire in the next couple years 2020 is probably too aggressive for you, I asked do they have 2015 fund but they do not have it they have a 2025 out. They do not have 2015 fund, so they have half decade funds. Again, we don't give investment advice to participants but you do have a retirement portfolio you could basically produce a synthetic 2015 fund by putting half your money in a retirement portfolio and half your money in the 2020 portfolio. Now, Alice got a license she could say that, I shouldn't.

You can basically produce a synthetic fund by putting half and half and make your own 2015 fund. This secure foundation fund which you again have the additional component beyond the standard target date funds basically have done relatively well, there's a lot of red but again there's a term we sometimes use call capture ratio, if the index is up 10 and your up 9.8 you have captured 98% of the upside. That's not half bad and yes we love 12 but what you don't want to see is where you've capture 50% of the gain or 200% of a loss we don't have that so the maximum funds are fine. The S&P 500 Index fund is tracking perfectly it did miss by 10 basis points for 3 months but that's nothing.

The Winslow fund is come back a little bit it had a bad period you can see it for 5 years it looks great had a bit of a bad period for 1 year and 9 months its now match the index and back to about medians which is coming back. The Windsor II fund which had a tough run for a bit is continuing to struggle a little bit, it's a multi-manager fund it's a blend of 3 or 4 different components. Again, looking at the capture ratio the index for one year for the Russell 1000 value is up 30.9% the fund was up 30.1%. I would say that's pretty close to the index it actually was in the 29<sup>th</sup> percentile. Franklin you can see is the one that's a concern we just need to see we've had now a variety of market environments. Baron is all over the place it's fairly concentrated portfolio but you can see some pretty strong numbers for the longer periods 14% a year for 3 years is more than a 50% increase it's approaching a 60% increase.


Champlain Small Company Fund you can see the longer period performance continues to be good it's had a bit of a struggle again there was a note written on that by our research people we still think the strategy is strong it's really just been out of favor. The two international funds the DFA continues to do very well both on a relative basis and an absolute basis little bit of a tough quarter but not terribly so. And the Thornburg continues to do quite well it's tailed-off a little bit for the last year

it's more of a value fund than a market where growth has been doing better. Again no recommended changes we think the participants are well served by the funds that you have. (Wilfred Aflague: so, no changes for this period) no changes for this period.

(At this time the Regular Investment Committee Meeting was called to order).

**Respectfully submitted,**

**Affirmed:**

  
\_\_\_\_\_  
**RENA CRUZ/MARILYN AGUON**  
Recording Secretary

  
\_\_\_\_\_  
**WILFRED P. LEON GUERRERO, Ed.D.**  
Investment Committee Chairman