Quarter Ended 3/31/12 Performance Meetings & Annual Manager Reviews

May 31, 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
Wilfred Aflague, Trustee

Staff Present:
Paula M. Blas, Director
Diane Bernardo, Controller
Rosalie Bordallo, General Accounting Supervisor

Other Present:
Maggie Ralbovsky, Wilshire

10:00am-10:45am Franklin Templeton

Wilfred Leon Guerrero: Okay Mike (Materasso) thank you very much for meeting with us. Just so you're reminded of who everyone is, you have Maggie (Ralbovsky), Gerry Cruz, the Chairman Joe T. (San Agustin), Paula (Blas), Lina (Leon Guerrero), Bill (Aflague), Diane (Bernardo), Rosalie (Bordallo) and I'm Fred (Leon Guerrero). It's a regular routine what we've done in the past and I believe that we put in writing of what it is that we want to get from the meeting and our

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share of possibilities and so we'll turn it over to you and interrupt whenever we feel like interrupting. Mike Materasso: Okay, that's fine.

Good morning everyone, nice to see you again. What I'd like to do over the next half hour to 45 minutes is obviously talk about the portfolio and the context of the performance in terms of the absolute performance as well as relative to the investment benchmark which is the Barclays aggregate index. From there talk a bit about our outlook for the economy and its impact on fixed income, U.S. fixed income and in turn how the portfolio is positioned and obviously answer any questions that you may have along the way.

If everyone would turn to page 6 of the presentation. I've been managing fixed income on a dedicated basis since the early 1980's and for most of my career which started in 1971 and I can say without any hesitation that the current fixed income environment that we're in today is unlike any other. As I said, I started on the dedicated way to fixed income in 1981 and back then we were dealing with double digit interest rates and inflation with 10 year treasuries at some point a couple of years later hitting 15 and ¾ and 16%. Well, this morning 10 year treasuries were at 1.6% and we're not in a deflationary environment, but there are so many factors that are having an impact on the U.S. fixed income market that have less to do with U.S. fundamentals but more to do with global risk factors and that's really been the story over the last 2 years. While the U.S. recovery has been sub-par, it has its structural problems, they're taking their time to work their way out to improve, the fact of the matter is that relative to Europe the U.S. is doing well. It is Europe and to a lesser extend China that are having an impact on the U.S. fixed income market in terms of the yields on treasury securities as well as the risk premiums that investors want to invest in corporate bonds, mortgage securities and other fixed income securities that have denominated in U.S. dollars.

So if you look on page 6 there are 3 tables or charts on this page. The first one on the upper left hand side of the page shows you the treasury yield curve at benchmark periods of time that you had asked me to address. The fiscal year from 9/30/2010 which is the red line to 9/30/2011 which is the gold line and you can see during that period of time that we had a significant decline in treasury rates across the yield curve, even with a downgrade of treasury credit from triple A to double A interest rates went lower rather than higher. Typically when the credit quality of an issuer weakens, it means that their interest rates go up and this case the even occurred and we had a global stock market decline and very large systemic risk concerns and in fact treasury rates declined. And then the most recent period which was April 30, 2012 and you can see compared to September 30th interest rates pretty much unchanged but a decent amount of volatility in between.

When you look on the right hand side of the page in terms of how benchmarks have done during this period of time as well as sectors of the fixed income market have performed relative to treasuries you'll see that looking at the first table at the top right hand side of the page the Barclays Aggregate Index has had some pretty decent returns during this period of time, keeping in mind that interest rates are very low, so as a result of that the coupon return that you're getting for fixed income right now is very low, but as interest rates have declined further and risk premiums of spreads to treasuries of corporate bonds and other securities have tightened introduced positive absolute returns as well as positive relative returns versus treasuries. Having said that, it's been a pretty bumpy road, it looks as though we're going on now 3 years in a row that as we enter the Spring season there are concerns that the U.S. economy is slowing, that happened last year and the year before last and coinciding with that European uncertainty also seems to escalate during this period of time and both of those have had an impact on interest rates especially treasuries and Buns, German Government bonds but also from time to time has caused spreads on corporate bonds and other securities to widen because of this overall concern about risk and looking for relatively risk free securities from a credit perspective and mainly treasuries and German Government bonds. But all in all as well as treasuries have done, investing in investment grade corporates, mortgage backed securities and other investment grade securities that we're permitted to invest in this portfolio have performed very well in among themselves and especially versus the equity asset class.

So let's talk about performance for the portfolio and this is on page 7. Kind of busy in terms of the tables that we're showing you but we wanted to follow the format in terms of the performance periods that you had asked us to address and those performance periods were the one year period of October 1, 2010 through September 30, 2011. When you look at the tables at the bottom of the page showing you the attribution, that is the one on the right hand side of the page, the fourth box. Then you would want us talk about 4th quarter 2011 performance, 1st quarter 2012 and then April of 2012 performance, so we've laid that out there. For this period of time first of all talking about the one year period, the fiscal year period you'll see at the bottom of the page that we under performed by 74 basis points with a return, gross of fees of 4.52 versus a return of the benchmark which is the Barclays Aggregate of 5.26%. The majors drivers of underperformance during this period of time was duration, we were a little bit short the benchmark and during this one year period as you've seen from the yield curve chart on the previous page that interest rates declined pretty significantly during that period of time. So for a portion of that time we were under weight in duration, probably on the average of about a quarter a year, but considering the decline it had that impact on the portfolio.

Investment grade corporates especially financials had a bit of a tough time during this period so overall it was about 20 basis points of under performance. While we were under weight in mortgage backed securities our security selection was very good so their net was a positive return of about 13 basis points. This portfolio is over weight in municipal bonds, mostly taxable, but to a smaller extent tax exempt bonds and for the period they under performed treasuries so you'll see a negative 10 basis points. So those are the major drivers that have impacted the portfolio netting out to about minus 75 or ¾ and 1% in under performance.

The 4th quarter as well was a difficult quarter, there we had spreads widening largely because of the concerns about Greece, how to --- the risk associated with Greece from the rest of Europe and it had an impact on corporate bonds and to a lesser extent mortgage backed securities, but also interest rates declined and net under performance of 23 basis points.

In the 1st quarter of this year we had a bit of a reversal, it's a period of time when interest rates rose a bit as well as the fact that because the European Central Bank put together a liquidity program for the banks called the "LTRO," they allowed the banks to receive collateralized funding for 3 years at low interest rates so they wouldn't have any type of funding problems. This was considered to be very beneficial. Also for the first couple of months of this year in the U.S. economical data looked very good and in fact in early March the Feds started to sound not hawkish but less --- than they did and for a short period of time interest rates interest rates on treasuries rose to about 2.4%. So during this period of time investment grade corporates did very well and as they say a risk on trade was put on by investors. So you'll see by being over weight in investment grade corporates, that's the 2nd box I'm referring to, as well as our issue selection, it was a combination of about 35 basis points. Also municipal bonds did very well during this period versus treasuries with 37 basis points, so net 50. We gave back a little bit of that in April. Concerns about Greece caused spreads to widen a bit and you'll see negative 18 basis points. So for the period since September 30, 2011 the portfolio out performed the benchmark by a little bit less than 10 basis points during this period in time.

Are there any questions regarding the performance of your portfolio? Joe T. San Agustin: I'm concerned, you mentioned something about you bought taxable municipal securities, what's the advantage of that for us? Mike Materasso: Well first of all it's a large segment in the investment grade fixed income market, typically --- single A better or higher... Joe T. San Agustin: And they're taxable? Mike Materasso: They're taxable and also when you look at them in terms of the default probabilities to comparably rated corporate bonds, the default probability is extremely low, almost non-existent and also the spreads are very attractive versus treasuries and versus investment grade corporates. Joe T. San Agustin: All in lieu of the fact that treasuries are so low? Mike Materasso: A combination of factors, a little bit that the treasury rates are low but we think that it is a way of diversifying our credit risk beyond investment grade corporates by taking State and local Government credit risk and our feeling is that the worst of the fiscal problems for the States are behind them and not they're out of the woods but that they seem to be leveling out and improving. Joe T. San Agustin: But they are taxable. Mike Materasso: They are taxable. What is the attraction to that, investment grade, because of the low interest rate on municipals the taxes versus taxable, what is the spread that you're looking at? Mike Materasso: The spreads are in the 200 basis points to 250 basis points greater than treasuries and these are for securities that are typically rated single A and double A and that's the yield to maturity. Joe T. San Agustin: 2%. Mike Materasso: 2% over. Joe T. San Agustin: Versus non-taxable. Mike Materasso: Versus treasuries. Joe T. San Agustin: Now what about other non-exempt? Mike Materasso: If you were looking to buy a tax exempt security of the same issuer, there right now the yields would be comparable to treasuries, so in other words if you were looking at a 10 year municipal, probably about 1 and ¾ percent. Joe T. San Agustin: Taxable or? Mike Materasso: Tax exempt. So here you're talking 1 and ¾ tax exempt versus 3 and ¾ - 4% tax exempt. Joe T. San Agustin: Taxable. Mike Materasso: Taxable, sorry.

So just as a recap in terms of not only performance attribution but in terms of portfolio positioning, we feel that interest rates on treasuries as marked by the 10 year treasury... Joe T. San Agustin: Before you go there, what was the average discount on municipals? Mike Materasso: The average discount typically were trading close to par so we weren't looking to buy these, it wasn't really an advantage of buying them at a discount, that wasn't the motivation, the motivation was more in terms of looking at the credit fundamentals of these issuers as well as their yields, extra yield that you are receiving over their tax exempt counterparts as well as treasuries, as well as investment grade corporates of the same credit quality, those were the driving forces, the specific price was not a... Joe T. San Agustin: Why would an issuer issue --- tax exempt --- taxable? Mike Materasso: Because the Treasury changed the law from municipalities a few years ago after 2008 so they issued a law which is referred to as the "Build America Bonds" and State and local Governments were allowed to issue taxable bond debt which in return they would receive a subsidy from the Treasury for the extra yield on the taxable bond. Joe T. San Agustin: 50%. Mike Materasso: Well in this case it was probably 35% of the extra yield. Joe T. San Agustin: And that yield is what? Mike Materasso: So just to give an example, just to give an example, referring to the 4% yield that I mentioned, so they issue at 4%, they get a subsidy from the Federal Government of 35% of that which is about 1.4% (something like that). Joe T. San Agustin: It sounds like a tax off-set. Mike Materasso: Yes. Joe T. San Agustin: So the investor is the one that took advantage of that. Mike Materasso: Investors took advantage of it, municipalities took advantage of it and what it provided for the municipalities as well was a larger investor base, so not just individuals that are looking for tax exempt income but pension funds and others... Joe T. San Agustin: Institutional investors will buy that. Mike Materasso: Exactly.

Joe T. San Agustin: I'm asking because we have current issues with GovGuam on the same catalyst. GovGuam has issued $100 million dollar bond of which 25 is taxable and that's just what I'm trying to understand, they still sell at a discount. Gerard Cruz: But that was priced at prime plus 1 and 5/8, not Treasury. Joe T. San Agustin: 4.6. Mike Materasso: It's a floater? Gerard Cruz: It's not a floater it's fixed. Joe T. San Agustin: It's negotiated, 4.6. Gerard Cruz: Yes, but it's single A, priced at 4 and 5/8. Mike Materasso: What's the maturity? Gerard Cruz: 30 years. Triple tax exempt and A rated. Mike Materasso: If the bonds are used for capital improvements then they get the subsidy for the Build America bond. Gerard Cruz: The reason why I think part of it was taxable because of the payment to us, part of the proceeds were used to pay past obligations. Paula Blas: You have to meet certain requirements in order to be issued a tax exempt, the nature of where the proceeds are going and because a portion of it was to pay past due contributions to the Fund it didn't fit the test for the requirement for tax exempt.

Gerard Cruz: I have a question regarding the state of our interest rate environment, your comment where a lot of the rates are in the long end has to do with things that are happening outside of the U.S., so more of a flight to quality than a fundamental problem domestically, so do you see that as a short term anomaly or given that it's, I don't know if this is similar or not, I'll let you be the judge but in 1998 when the Asian economic crisis was happening we saw a similar flight towards U.S. Treasuries and nothing to do with what was happening in the U.S., so is this something similar? Mike Materasso: Well this is actually much more complex and much more serious than the Asian crisis that occurred in the late 1990's. I thought you were going to make reference to... Maggie Ralbovsky: The 1930's. Mike Materasso: Or the Japanese interest rate environment. A lot of people ask, so where should the treasury yield curve be today, where should the 10 year treasury yield be today and probably when you take into consideration the Fed's influence on interest rates in terms of purchases of treasuries, so right now they have this program called "Operation Twist," they have this large investment portfolio that has a lot of short dated treasury notes and what they've done rather than expand their balance sheet by just buying outright more treasuries to help the economy by keeping interest rates low and providing liquidity to the markets. They in turn are selling their short securities and they're buying longer securities and they're selling securities out to 3 or 4 years and they're buying securities typically 7 years and longer and it's estimated that if they weren't doing this, that if the Operation Twist wasn't in effect, probably the interest rates on treasuries would be about 50 basis points, so one half of 1% higher than they are today.

In addition to that we have this tremendous concern about what happens to Europe. Europe has a situation where there is a monetary tie, but there isn't a fiscal tie and they set up a set of rules in terms of how you had to manage your countries from a fiscal perspective and most countries didn't and they took advantage of low interest rates and they took on too much debt, both Governments as well as individuals and the financial system, so they're in a big mess right now. Besides being in a big mess, most of those countries in Europe are also in a recession, a slight recession. So there is this concern that it starts off with Greece, now possibly is Spain the next country and Spain is significantly larger than Greece, Greece is very small, small banking system as well as small economy, but Spain is very large, it has a very large banking system, that's one of the problems within Europe that doesn't exist in the United States. Many of the banking systems because they're global banks are much larger than their economies, so that as an example, I think the UK's banking system is double the size of their economy, Spain is a similar situation. When their banks get into trouble it's a big risk for the country itself because it's so large relative to the countries economy. These factors because of the uncertainty, because you're dealing with 17 different countries that have to agree in most instances unanimously on a decision to make that you have this problem where there is, how is this going to work out? As things delay, as things are pushed off, it seems as though the situation is worsening. So this has definitely had an impact on Treasury rates, so despite the fact that the U.S. economy has a deficit of over a trillion dollars a year, the Federal budget, despite the fact that we had a credit downgrade, despite the fact over a period of time, we seem to be the best of the worst and so therefore interest rates continue to decline.

Our view is that especially for Europe that you need this chaotic situation, this loss of confidence situation for politicians to get together and do what is necessary rather than stay on their political, stand strong on their political views in terms of one way or the other and we feel that process is coming and probably coming pretty soon that it's probably over the next 2 months, but it probably means that in the near term there will be further volatility. So from my perspective and our firm's perspective, if we could see treasury interest rates on 10 years between 2 and a half and 3% rather than 1.60 to 2% and still feel that we're in a low interest rate environment that treasury rates are still very low and that it doesn't mean that the economy is accelerating and there are going to be inflationary concerns, but we feel below 2% that these rates are just low and there are risk factors that are currently weighing positively on Treasury rates in terms of bringing them down than more temporary. The big question is how long is temporary? Temporary typically use to be 6 weeks. 1998 is a good example, in the summer you had Russia defaulting on its debt, Treasury rates declined and by October they reversed themselves, so usually the Fed comes in and the Central Banks come in as that safety net, they provide the safety net for the global economy, for the global market systems, the global banking systems and from there confidence starts to rebuild. This situation is much greater and a lot of tools have already been used and looking back in hindsight, in many cases they didn't seem to be all that affected. So these are reasons why Treasury rates are as low as they are but we do feel that they are ridiculously low and ridiculously unattractive.

Now I mentioned to you that from a duration perspective that the portfolio is under weight and you also saw in terms of performance that its attribution has had a negative impact on the portfolio because interest rates have declined. We don't want to shorten the portfolio further because we're over weight in investment grade corporate bonds and we're over weight in municipal credit and as credit, typically when interest rates decline credit under performs, when interest rates rise, credit out performs. So our view is that with the under weight in Treasury duration as well as the over weight in credit, we're positioned for recovery in the markets and in turn therefore higher interest rates will tie to credit spreads. Right now the average investment grade corporate bond has a yield of a little bit over 2% greater than treasuries. When you look back historically, that 2% extra yield on a corporate versus treasuries typically was when you were in a recessionary environment and we're not in a recessionary environment at all.

Let me tell you another reason why we feel that interest rates are too low on treasuries, despite all the concern that the U.S. economy is performing relatively poorly compared to past recoveries, our view is that the economy is gradually on track to improve with some --- and starts and --- and flows in terms of quarter to quarter and in the near term that is over the next 6 months we think that we'll see an improvement in the U.S. economy and one reason for that is inflation. In an economy where individuals don't have access to credit, individuals don't have access to credit because of the high unemployment rate so those people have poor credit scores, for those that have, there is no equity in their home so they can't borrow against their home and also bank's lending standards are very high. When inflation rises you have a finite amount of money to live by and what does it mean using simplistically the price of gasoline goes up as it did last year. When gasoline prices go up and you have a finite amount of money in terms of discretionary income, you spend less on something else to pay for the higher gasoline prices. In the past you said, you know what, this is temporary, I'll just use my credit card and pay it off over the next 6 months, but this time around many can't do that because they're tapped out in terms of credit, how much credit they have available. Conversely when inflation declines it's a positive to the consumer and we're in that environment right now. Commodity prices are coming down, both on industrial commodities as well as food and as well as energy and this will be a boost to the economy for consumers. Now the reverse is true, you're spending less on food and energy than you did 6 months ago, so as a result of that you have more disposable income to spend on other things. In addition to that it's good for corporations because the materials that they use to make their products, the price of that is coming down a little bit, so that's a boost. So we see and if you take a look at the U.S. economy over the last 3 years you'll see this relationship between inflation rising and the economy slowing, inflation declining and the economy picks up. This is all within a relatively low framework of growth between 1.5 and 3%. So we're not looking for the economy to accelerate and to go to 4% plus, we think it's in that range but it's a good range. So as these global risk factors lessen a bit we think that causes interest rates to rise, as it's apparent that the U.S. economy is not headed for recession, we think that's another reason we think that's why interest rates rise, so that's the reason why we are short duration at this current point.

I mentioned to you that investment grade corporates, we feel that from a bottom up perspective in terms of credit fundamentals, corporate balance sheets look very good, so as a result of that from a credit perspective we're very positive on corporates. We look at valuations as I mentioned to you before, we think that they are on the undervalued side and it's for those reasons that we have a 5% over weight in the investment grade corporate bonds. I will mention to you as well that while we're over weight in investment grade corporate bonds by 5%, we do not own any foreign corporate bonds, we do not own any foreign issuers in the portfolio. Even though I was asking you for permission to do so in terms of expanding the guidelines, currently because of our concerns about credits outside the U.S., we don't have any exposure to foreign corporates, foreign sovereign credit issuing their dollars or anything like that, so all the credits are U.S. credits that are in the portfolio and I mentioned my comments earlier about municipal bonds in terms of --- in terms of where we see municipal credit quality gradually improving and also valuations look very good.

So our view on the economy is not bullish but it's constructive, our view on risk is that at some point investors will be willing to take risk again and that implies tighter spreads on credits as well as higher interest rates on the base rates for treasuries, but not significantly higher, we're not talking about inflation taking off as a result of that you end up with 10 year treasuries at 4 - 4.5%. We really don't see that and if that happened in the short term it would probably hurt the economy and slow it down, but we don't see any reason for that, we feel that this de-leveraging process that's going on in the United States as well globally it will take years and we're only about 3 – 4 years in that process and that probably has a few more years to go.

Another slightly positive or less negative aspect of the U.S. economy is the housing market, it seems as though it is leveling off in terms of the decline and it's poised to start to recover but once again very slowly but rather than being a drag on economic growth, we think it will be slightly positive in terms of adding to economic growth.

The last factor will be this fiscal cliff that everybody talks about at the end of this year, in other words the Bush tax cuts, the payroll tax holiday expire as well as spending cuts take hold in 2013 and if you just do the math in terms of what these cuts as well as tax increases would cause it's something on the order of $550 million dollars or 3.5% of the economy and think about the multiplier effect if the fall of that was to happen, our feeling is that despite the distance between the Republicans and the Democrats on fiscal policy post election they do get it, that it does have to be worked out that they do have to come up with some solutions, they may not be the optimal ones but we feel as though they will be solutions that will be positive for the economy and positive for the markets as well.

When you think about the uncertainty that exists for corporations doing business in the United States, at the margin it has to have a slight negative impact on the economy in terms of forward planning, what will my corporate tax rate be, when will this payroll tax holiday expire and other issues as well. As they start to attack and resolve these issues I think it lifts some of that uncertainty for corporations, I think it will allow them to spend a little bit more in terms of investment spending as well as hire people as well. Not tremendously but still being more in the positive additive to growth rather than slightly negative to growth.

Wilfred Leon Guerrero: Your mandate restriction to investing only in U.S... Mike Materasso: In U.S. dollar denominate, so only U.S. dollar denominated issues. The mandate allows to buy foreign issuers that issue in U.S. dollars. Wilfred Leon Guerrero: Do you invest in other than U.S.? Mike Materasso: We do, as a matter of fact if you were to look at our assets under management, probably more than half of our assets under management for fixed income are denominated in foreign currencies. Wilfred Leon Guerrero: What is the return on that? Mike Materasso: The return on that is going to be influenced by currencies as well, I included because Maggie (Ralbovsky) asked mentioned to us that you're thinking about expanding your investment guidelines over the next couple of years, we included in the back of the presentation book 3 of our strategies that include, one is a high yield fund, the other is a non-dollar bond fund and then the 3rd one is an emerging markets bond fund. In all of these areas we have expertise and significant amount of assets under management, very good performance, credit research, tremendous credit research from the bottom up as well as from the top down. So, we would agree with Wilshire in the extent that you can diversify a bit your fixed income, that just makes sense. As we mentioned we're dealing with, you're looking at the developed world, you're dealing with countries that are growing very slowly or not at all, countries that have a lot of debt that they have to bring down so the credit fundamentals of the better higher credit quality countries is not all that good, it's deteriorating. So to the extent that you do so judiciously in terms of risk profile of the pension fund that you can get diversification but also diversification in parts of the fixed income markets that seem to have better fundamentals than where you currently are.

Gerard Cruz: Just 2 quick questions and then I'll just stop there. I hear your message and you're attracting this to munis and corporates, inside the corporate space do you find opportunity in financials? Mike Materasso: We do and it's been very tough. We do because we feel as though while there is a lot of uncertainty with Dodd Frank as well as the vocal rule we feel that U.S. banks are in a much better position from a capital perspective as well as asset quality than European banks, that's the reason that we don't own European banks in the portfolio. Having said that, they're spreads are very wide. They've tightened and now they've widened again, including JP Morgan which was considered to be one of the best. JP Morgan and Wells are considered to be of the large banks, the major banks, to be the best and those with the tightest spreads and JP Morgan because of this problem, this hedging problem their spreads have widened, but we do, we do believe that they are. Many of the regulations that they once put into effect are actually positive for bond holders in terms of isolating, reducing risk, reducing leverage, things of that nature as a bond holder I'm happy about that, I'm not concerned about the return on equity, I'm more concerned about the credit quality of the institution so it's definitely a positive from that perspective but it's also creating a lot of uncertainty and it's reflected in the spreads, so we do like U.S. Financials. Gerard Cruz: What part of the corporates are in U.S. financials? I mean, of your holdings, I was looking for that. Mike Materasso: We don't break it out that way. Gerard Cruz: You can just ballpark it, I'm just curious. Mike Materasso: We have 25% of the portfolio in corporate bonds and that compares to 20% for the benchmark and I would say probably about 8 – 10%, probably 10 – 11 because they're a couple of insurance companies in there as well, so let's say 10% plus or minus would be in financials including banks. Gerard Cruz: And then my final question, on the mortgage backs and commercial mortgage backs, these are agencies? Mike Materasso: So the mortgage pass thru securities are agency mortgage pass thru securities, so they are Fannie, Freddie and GNMA. We own 2 mortgage backed securities, both of them are triple A rated, they're both trading at 110/112 dollar prices so that they are very safe, they have tremendous collateral protection. Gerard Cruz: The coupon rate on those are? Because those long, those are 30 years I guess. Mike Materasso: No. The agency mortgage pass thrus are quite short, they're only about 5 years. The 2 issues, the coupons on them are, the average life is about 4 and 5 years.

Maggie Ralbovsky: What would be a contribution from high yield --- allocation? Mike Materasso: That would be the Lehman bond. So the Lehman bond has been doing relatively well, it's hard to say that's it's been doing well when it's defaulted and we bought it at par but when you look at it in terms of when since we last met, when we last met which was in July of last year, the bond was trading at .24 cents on the dollar, it made one distribution of a little bit over .6 cents and is trading at about .24 so it's gone up about 25% in price, the return has been 25% over the last year, that translates into the positive returns that you are seeing from high yield because it's an issue that we continue own with permission. There we continue to believe that the recovery value on this security ultimately is .35 - .40 cents so considering when you put back the distribution, it's trading at about .30, our view is that recovery should be over the next 2 years and our positive view on commercial real estate which a lot of the assets that's part of Lehman, our view is to continue to own it because we think that looking at, even though it's not paying interest, it's flat that the total return on the security especially over the next year should be attractive relative to other investments and we feel the downside risk is relatively small.

Wilfred Leon Guerrero: Okay, any other questions? Thank you very much. Mike Materasso: Thank you. Thank you for having me in.

Paula Blas: Housekeeping. Gerard Cruz: Just the housekeeping questions. Wilfred Leon Guerrero: Any regulatory agencies after you? Mike Materasso: No. Rosalie Bordallo: Any major organizational changes that we should be aware of? Mike Materasso: No. If anything within the fixed income group we continue to add individuals. I think we have now about 140 investment professionals within the fixed income group. Thank you very much.
(End of presentation by Franklin Templeton)

<u>11:00am-11:45am Investment Statues</u>

(Start of tape 1)
Maggie Ralbovsky: This is a continued discussion from last quarter. Why don't we summarize where we are from last quarter. We discussed certain items in the current statute during the last quarterly meeting, specifically there were 3 things we discussed. During the Board meeting on February 24, 2012, among the 3 things we discussed one item was approved and that item was to allow up to 25% of the fixed income allocation to be invested in high yield bonds. I understand we have to go to the Legislature, but as far as we're concerned this item has been approved. There are 2 additional items I would like to discuss, we did have a preliminary discussion last time and the Committee has told me there was not sufficient information provided so I have tried to provide some more information and hopefully I can get some feedback from the Committee whether it is sufficient at this point to have further discussion on these 2 items. These 2 items are number one, for the home country bias in the statute which is currently imposing a 15% limit on international stocks, international equity. Number 2 item is the fact that the limits for commingled funds and mutual funds do not take into consideration what kind of investments are in those funds and I'd like to keep that limit but to expand the definition of that limit to not just constrain the investment vehicle but rather look through to see what's inside the vehicle. These are the 2 pending items I'd like to discuss. I do have a summary of the current statute in terms of the different items and we can come back to this, I'm not going to go through that.

The first tab is focusing on global equity, it says "Investing Globally." On page 5 we listed the different weightings based on different measures of the world. On the left hand side this pie chart summarizes the global capitalization, so you can think of that as the global market opportunity set, so if you are a neutral person trying to be neutral to what is available out there that can be bought in the public market, here is the weighting, so you summarize all the publicly traded securities in the world... Antolina Leon Guerrero: And 46% are owned by U.S. companies? Maggie Ralbovsky: Yes that's right and in Europe ex-UK is about 16% and UK 8%, emerging markets 13%, Japan 8% and the rest about 10%. This is one definition of the global opportunity set. One can also argue about an alternative weighting which is to say, what is the GDP contribution for the world and with that definition you can see the global opportunity set defines the U.S. at about 20%, so the entire global GDP only 20% comes from the U.S. I want to provide these 2 data points to put into context of the limitation of investing internationally, we're basically really constraining ourselves to not only by definition the available opportunity set but also the participation in the global GDP production.

Okay, how does our allocation compare to the peer group, that starts on the next page. This page, this kind of graph we used public funds with assets at least $1 billion dollars so it's comparing $1–5 billion dollars public funds in the U.S. I graph the current allocation for our fund today including U.S. equity of 40% and U.S. REITS of 10%, that's 50% allocation into the U.S. equity and that compared to the universe you can see we start from the right hand side in 1996 and you can see the weighting for this universe in terms of U.S. equity has been steadily going down. This is a trend of the recognition of the expanding global opportunity set and most public pension funds are trying to recognize that reality accordingly and adjust their allocation to be less and less concentrated in the U.S. equity category. You can see that our current allocation of 50% U.S. equity was pretty much in the range 10 years ago. Antolina Leon Guerrero: What are these different boxes? Maggie Ralbovsky: The top line is the 10th percentile, the bottom line is the 90th percentile. For example, 1996, 10% of the funds have more than 54% of the allocation to U.S. equity, that's how you read it. Gerard Cruz: 10% of the funds surveyed? Maggie Ralbovsky: In the universe. Gerard Cruz: Had more than 50%... Maggie Ralbovsky: 54% and above. Gerard Cruz: In domestic equity. Maggie Ralbovsky: In U.S. equity, that's right. Joe T. San Agustin: Our line is the red line. Maggie Ralbovsky: Your line is the red line and you can see you are in the range if you compare to 1996 and if you compare to 2012 you're way out of the universe. Antolina Leon Guerrero: But I'm curious, everybody changes their allocation with regards to U.S. equity, how did they all perform? Maggie Ralbovsky: Okay, this is another discussion, later on I do have some numbers I can discuss but can we just stick to this, I want to show you... Antolina Leon Guerrero: I'm just curious. Joe T. San Agustin: What does it mean to us? What does it mean to our pocketbook? Antolina Leon Guerrero: So now we're way over weighted in U.S. equity compared to... Maggie Ralbovsky: It means you are very concentrated in U.S. equity, if U.S. equity does well, you do well. Joe T. San Agustin: Is that good or what? Maggie Ralbovsky: Well that obviously is a question that we have to discuss. Why do we want to constrain ourselves to a limited opportunity set, that's my question for you. Joe T. San Agustin: The question is, what is it costing us? Maggie Ralbovsky: Can we move on and hopefully I can answer that question later.

The next page is the same universe information for non-U.S. equity allocation in the same universe of a public fund $1–5 billion dollars and you can see that's the opposite of the trend that the universe is allocating more and more into the non-U.S. equity fund and I did draw a line which is our 15% statute of limit.

The next page which we looked at yesterday is trying to highlight the point that our allocation has a very large concentration in U.S. equity therefore our universe comparison is highly correlated with U.S. equity return, so we know this month for example, U.S. equity is down.

The next page continues to discuss the drivers of return. The world is changing so this page is trying to decompose how much contribution of a company's stock return comes from a company's specific risk versus a sector risk, industry risk or country risk. The points to focus on this page are the bottom green panel which is showing the country factor contribution to total return. We know that the reason historically we constrained our allocation to international equity is because there are different risk factors, in foreign countries we want to be mindful of that risk factor. Has that risk factor changed and the observation has been that the contribution to a stock return has shrunk from historically around 50% in the 1970's to today's in the teens in less than 20% of the contribution. The majority of a company's sources of return in terms of the stock return is not coming from the country factor, because of the globalization a lot of the factors have changed significantly. Should we be recognizing that fact, the fact that the world has changed and should we be considering expanding our opportunity set, that's a question mark here. Joe T. San Agustin: But you have to identify what country and what sector.

Maggie Ralbovsky: Let's move on. Let me show you another example why globalization has changed the world. On the next page I listed 4 automobile companies, Ford Motor Company, this is a U.S. company located in Dearborn, Michigan. Toyota Motor Company is a Japanese company, BMW is a German company and Hyundai is a South Korean company. Now these 4 companies are in different indexes of the world and only one company is in the U.S. in terms of definition of U.S. company. I want you to focus on the percent of units produced in local currency and also percent of units sold in local currency and you can see that Ford Motor Company even though it is a U.S. company it actually has a majority of their sales outside of the U.S. Same thing for all the other companies, majority of their sales, it's such a global phenomenon that is doesn't really matter where a company is located. Why would we define our opportunity set by where the company is located, they're competing with other countries at this point. Gerard Cruz: Can I just ask this question, because I think it's relevant to this page. So in this example that you just gave where a company like Ford who has most of it's product sold outside the U.S., the fact that we would hypothetically be investing in Ford wouldn't that then result in being invested globally since most of the revenues come from the global? Maggie Ralbovsky: Yes. You can make such a case to say, you know what, I just bought these global companies, I am diversified globally; however you are constraining your opportunity set in Ford and ignoring the fact that Ford may be weaker than the rest of the competing car companies and by definition you have to overweight them. Gerard Cruz: So if we went in your direction and opened it up to a global set, would we then run the risk of being overweight on foreign equities because then we would own Toyota and Ford? Both companies by definition would be considered global? Maggie Ralbovsky: If you run a global mandate the manager will comparing these 4 companies based on their profitability based on which one is cheaper, disregard where the company is located. So you are giving an asset manager the tools they should use to focus on profitability which eventually drives the security return. Gerard Cruz: I understand, but if we set up a global mandate and have a global manager run that mandate and then at the same time have domestic value and then say a domestic growth, isn't there a greater likelihood that all these managers would view the same company as being part of their investable mandate and therefore maybe have a higher concentration, I mean isn't there a greater risk of having a higher concentration if all the managers look at the entire universe in almost the same way? Maggie Ralbovsky: Well in a global mandate you still constrain a manager to say 50% maximum international equity defined by the country. Gerard Cruz: So what would you say about a company that does the most business in the U.S. but is domicile incorporated in let's say the Grand Caymans? Maggie Ralbovsky: I think people shouldn't be indifferent of where the company is located but rather have the company be compared to their global competitors in the same sector rather than the same country. Gerard Cruz: So then would we need to have domestic managers then given that? Maggie Ralbovsky: We probably still need domestic managers; you could theoretically have all global managers. Gerard Cruz: I guess where I'm going and maybe this is a couple of steps ahead now, trying to find where a global mandate would fit in our current... Maggie Ralbovsky: I can answer that question later, I already ran some optimizations.

Here we were just trying to make a point to say really it doesn't matter where the company is located, we all compete in the global market place and why wouldn't a manager be given the opportunity to compare them across the board based on the fundamentals of the company, disregard where the company is located. Joe T. San Agustin: And your point is we're constrained by local statutes. Maggie Ralbovsky: That's right. Gerard Cruz: By 15%. And 15% also included international bonds and all that.

So now look at historical returns and here is a backward looking figure to say what happened compared to our current target. The blue chart is the current target, the blue line in the chart, it says growth of a dollar we graphed this since 2002, the blue line is your current allocation, your current target, the U.S. international blend and that target of yours and the red line is the 50/50, so what if we didn't do the current constrained markets but rather do the 50/50, more or less being neutral to the global opportunity set and you can see that $1 dollar since 2002 would have contributed 20 cents more which based on a billion dollar invested in equity you would have generated $100 million dollars more in this period. Joe T. San Agustin: But the spread is not so wide. Maggie Ralbovsky: That's 20 cents of $1 dollar. Joe T. San Agustin: But that's 20 cents of risk exposure, is it worth it? Maggie Ralbovsky: Okay, here's the risk and return, how much more risk are you taking? I'm trying to answer your question. Look at the risk, it's 17.1, if you go to 50/50 it's 17.9, so less than 1% of risk addition and the return is more than... Joe T. San Agustin: But your marginal of sensitivity either way is what, 5, 2%. Maggie Ralbovsky: The marginal contribution is 20% more. Joe T. San Agustin: But your spread that's affordable and not affordable in terms of risk management, how much can I afford to risk? I can get my hand extended out but how far can I extend it out? Maggie Ralbovsky: It's very little, it's less than 1%. Joe T. San Agustin: I'm talking about, what is our investment opportunity loss? Maggie Ralbovsky: The opportunity loss is $200 million in the last 10 years. Joe T. San Agustin: But if we had gone the other way we would have lost twice that much. Maggie Ralbovsky: What do you mean? You would have made $200 million dollars more. Joe T. San Agustin: If we had gone the other way. Paula Blas: On the growth of $1 dollar, your period is March 2003 to...

Maggie Ralbovsky: It's 10 years. Paula Blas: That doesn't match with your graph. Maggie Ralbovsky: What do you mean? Antolina Leon Guerrero: Your graph says January 2004 to May 2011. No it's just the legend when you run the graph. It starts from March 31, 2003, that was the first point. If I print out all the time periods it's going to be too crowded. Antolina Leon Guerrero: So this is correct? Maggie Ralbovsky: It's correct. It starts with $1 dollar on March 31, 2003. So for the last 10 years the 50/50 policy would have generated $200 million dollars more on a billion dollars. Joe T. San Agustin: Maybe you should go to one more chart down, that's what I'm talking about, as a sharp ratio less the spread right there. Maggie Ralbovsky: I have the sharpe ratio here, that's the bottom. The sharpe ratio, the current policy is 0.24, the 50/50 is 0.28. The sortino ratio less of a downside, the 50/50 ratio also has less of a downside risk, has a higher sortino ratio which is the good volatility ratio, the risk return is also higher, so by every measure it is a better risk trade off. If you think of a return around the means, if someone tells you on average something is going to return 10%, what is average? Sometimes it's going to be below 10%, sometimes it's going to be above 10%. If you calculate the sharpe ratio you are considering the volatility on both sides equally, you're saying good volatility is the same as bad volatility, I'm going to punish it, I'm going to calculate the total return divided by the volatility. The sortino ratio is saying, no, I only care about, I think the upside volatility is good volatility, downside is bad volatility, I'm going to punish the downside volatility and see how much I can get by taking a downside volatility, so it's a semi-variance in terms of the jargon.

Wilfred Leon Guerrero: On this chart, the red one is the global asset allocation? Maggie Ralbovsky: That's right, it's global. Wilfred Leon Guerrero: That's riskier than the one we have right now. Maggie Ralbovsky: That's right, but it has better return and all the ratios are saying you're taking the right kind of risk, the risk isn't that much more, it's 80 basis points more. Wilfred Leon Guerrero: I'm getting mixed messages from you. Maggie Ralbovsky: How is that? Wilfred Leon Guerrero: You're telling us we need to protect the fund basically, but yet now you're talking about taking more risk. Maggie Ralbovsky: No, that's not what I said, what I said is we need to take the smart kind of risk, we have to take risk but how do you use your risk budget, that's a huge question. Currently the risk budget is used in a way that is concentrated in one kind of risk. I want not to reduce your risk budget, but rather use the risk budget in a more diversified way, therefore get better results. That's the goal, it's not to constrain your risk taking, but rather to take the risk more prudently and prudence means we need to recognize the changing world, we need to evolve. Joe T. San Agustin: We know that we're living in a changing world. Maggie Ralbovsky: Right and I want to show you the world will change, since the 1970's the universe has changed and I want to ask to open our mind and consider whether we should change as well. Wilfred Leon Guerrero: The message that I'm getting from you all this time when we discuss this is we're taking unnecessary risk. Maggie Ralbovsky: You're taking concentrated risk in one factor and that is U.S. growth, it's a concentrated risk, it's not that you're taking too much risk, but taking too much of one kind of risk. Antolina Leon Guerrero: So you're really just asking us to look at our diversification and just increase our diversification. Maggie Ralbovsky: That's right, that's exactly what I'm saying. Joe T. San Agustin: If you have diversification then you'll be getting out of the U.S. market, that's what you're saying. Antolina Leon Guerrero: I don't think it's getting out of the U.S. market, I think it's just recognizing, I think it's just historical, we've seen across the world, it just develops and that's all she's (Maggie Ralbovsky) saying is to recognize that.

Rosalie Bordallo: Can you explain what's the make up of the GGRF current targets? Maggie Ralbovsky: It's the current policy.

On the next page the policy, A, B, C, D, E, F, G, H, these policies I only changed one factor in doing the optimization and that factor is to allow the optimizer to pick global equity not constrained by the 15% global constraint. Rosalie Bordallo: Okay, that's where I'm getting confused. You're using a 15% global constraint yet in our current make up it's more than 15%. Maggie Ralbovsky: Right, I used your current to calculate this but when I did the optimization I broke the 15% constraint. Rosalie Bordallo: But we don't have a 15% constraint. Maggie Ralbovsky: You do in the statute. Rosalie Bordallo: But in a certain type we basically tweaked it to go beyond the 15%. Maggie Ralbovsky: Well yes, that is correct, but that is not impacting the result here. I take your comment. Joe T. San Agustin: Our tweaking is not much of an impact? Maggie Ralbovsky: No, I used your current actual allocation here. You can see the allocation is 15% EAFE and 5% EM so you do have 20% allocation right now. If I have to run your current optimization based on your current statute, there is nothing you can do with your current policy, there is no way you can improve your current policy anymore because it's bumping towards all kinds of constraints right now.

So in this optimization I say let's just relax one constraint and that is the global opportunity set constraint. Let the optimizer pick a global equity, let the optimizer do whatever the optimizer wants to do in terms of global equity. Okay, that's the only thing I changed, I did not add high yield, I did not add commodities, I did not add any of this stuff. The only thing I changed in this optimization is to relax the global equity constraint. Joe T. San Agustin: At what cost, at what risk? Maggie Ralbovsky: This is what I'm trying to show you. Forward looking on a forward looking basis these blue diamond shapes shows you our expected return for the different policies out there. I highlighted C and D because C and D are the closest to the risk taking level of the current policy and you can see the current policy is the forward looking basis is the yellow square, it's in that yellow bubble and C and D both can be better than the current policy without taking too much risk.

Now to test whether our projection is consistent with historical observation, I graphed the historical achieved return in this top current bubble which has C and D and current policy and the relationship is very similar to the forward looking which is to say our expected scenario in the future is consistent in terms of relationship of the past; however, returns have been coming down, you can see our projected return has come down significantly from historical levels and that is consistent with the risk free rate because all risky assets are priced based on risk free rates, all the people who take risk are demanding additional return as a spread over the risk free rate.

Now today 10 year treasury closed at 1.63%, that is Lehman level. When Lehman went under that was the level, 1.6%. The world is pricing into very little return scenario for the future, so the future expected return being lower than the past achieved is very consistent with the fundamental relationship of asset class pricing. Antolina Leon Guerrero: So if years are unchanged what we can expect in terms of return is the yellow square which is a lower return? Maggie Ralbovsky: That's right, that's the current policy. Antolina Leon Guerrero: If nothing changed this is what we would project to get as a return? Maggie Ralbovsky: That's right and I also graphed the red dot which is the actual achieved which is less than the policy because we said yesterday that the policy was changed, obviously it was changed for the better. The relationship all works out to be consistent with our understanding of fundamentals that drive the return. My point here is just by relaxing the global equity constraint we can do better otherwise we cannot do better, we are bumping against all kinds of constraints right now. Antolina Leon Guerrero: And where is this global equity constraint in the statute? Gerard Cruz: It doesn't exist. Maggie Ralbovsky: The constraint is 15%. I know you try to give a little bit more flexibility by adding 30% into commingled funds, but what I'm saying is that in this optimization we just forgot about the 15%. Antolina Leon Guerrero: I understand that. So the statute is currently limited to 15%. Gerard Cruz: International equity, non-U.S. Maggie Ralbovsky: That's right.

Joe T. San Agustin: We're talking about 15% of the total, $1billion dollars, we're talking about a very minimal amount, limited. Maggie Ralbovsky: Maximum. Joe T. San Agustin: How much more do you want to add to the 15%? Maggie Ralbovsky: I want to go to 50% of the total equity allocation. Currently you have 70% to equity right now, so I want to do 25%. Gerard Cruz: 70% equity is inclusive of the commingled mutual funds and includes REITS. Joe T. San Agustin: Of the 70% you want to bring down to 50/50, so it's still 30% exposure to someplace else, a fall back. What you're doing is, we want to stretch our hand out by 70% out, 50% is risk level and overall we'll only have 35% fallback if something happened because that's what's left. Are you following what I'm getting at? How long is my neck going to be stretched out that I can yank it back fast if something happens? Maggie Ralbovsky: Well you could have all 70% U.S. equities, we're just trying to set a maximum. Joe T. San Agustin: You're saying that it's costing us to have that kind of constraint of 70%. Gerard Cruz: To have the constraint of being U.S. Paula Blas: There is a concentration.

Wilfred Leon Guerrero: Just so that we understand each other, what you have just told us is that the current policy that we have in place is we're maxing it, we can't go... Maggie Ralbovsky: Yes, you cannot improve because you run an optimization based on your current constraint, you're at the maximum good point of the efficient frontier, there is no way you can improve it anymore. Wilfred Leon Guerrero: We can't make anymore money? We can still make money, what's she's (Maggie Ralbovsky) saying is we can't improve on the opportunities. Maggie Ralbovsky: That's right. Gerard Cruz: We're at the point of maximum opportunities. Antolina Leon Guerrero: Right, with the current policy the way it is. Wilfred Leon Guerrero: Which is what? 14% return? Gerard Cruz: The expected return going forward is 6.33%. 6.33 is our expected return in our current asset allocation. Joe T. San Agustin: Of what? Gerard Cruz: Overall. Expected return as of today is 6.33%. That's changed though, right because when we put this together when rates were a little higher the expected return was 8.4% and that's why we set the actuarial rate at 7%, but rates have come down since we last had done this and so what Maggie (Ralbovsky) is saying now is that the expected return is closer to 6.3%. The improvement going in the direction is to 6.4% under scenario C with the same level of variability. Maggie Ralbovsky: This is just to relax one constraint, I do have some other analysis to relax other constraints. Gerard Cruz: The challenge is trying to get this through the Legislature. Maggie Ralbovsky: I understand but we have to take the first step first. I know, but the problem is that doing it piecemeal is what scares me. Maggie Ralbovsky: That's right, not doing it piecemeal, I hope to have a wholesome change. Gerard Cruz: I'd feel more comfortable because just changing the global piece now for me runs the risk of having unintended consequences on other parts of our portfolio, stuff that we're not even contemplating at this point.

Rosalie Bordallo: Can I ask? Look at your C and you're going global equity 24, global equity is suppose to be 50/50, so you're saying 12% in essence is going to be U.S, so that's 12%. Now you have 23 on top, you go back to 35 you're basically... Maggie Ralbovsky: No, you have another 11 here, EAFE and EM. Rosalie Bordallo: No, I'm talking about the 24 global equity... Antolina Leon Guerrero: 12 plus 23 is 35 in U.S. Rosalie Bordallo: Right, in U.S., so you're really, in essence we're kind of staying in the same boat. I mean if you have global the current allocation right now kind of just mirrors this global. I don't get what the purpose of the global if you're just kind of saying it's a term global but it's really 50/50 and the 12% is really still... I mean it's not... Maggie Ralbovsky: So you're saying I could have put, allocate to 12% to EAFE and EM? Rosalie Bordallo: Yes, in essence it would still serve your global purpose. Why do you have a mandate that really is for global when you can just break the thing apart and say, okay, give me half. Maggie Ralbovsky: It's actually better. I think I skipped this page. That's a great question because I skipped this page. I was trying to explain that, why instead of having U.S., EM and EAFE to combine together as global, why don't we have that and just instead have a global mandate? The reason is the global managers actually can do value Asian trade among the 3 pieces. When you give them a mandate of U.S., give them a mandate of EAFE, give them a mandate of EM, they are constrained to that category, so nobody is doing the cross comparison in terms of these 3 regions other than us. So we arbitrarily say you do this much in U.S. and you do this much in EM and you do this much in EAFE, compare that with a model that a manager actually compares these different categories and his tilts in different, overweight in different regions depends on the relative value. We have observed this kind of mandate actually adds value, then combine these 3 pieces in a rigid way. Does that make sense? That's why global mandate can be actually used as a separate category in the optimization because it actually achieves a certain goal that these 3 pieces in piecemeal cannot achieve which is a cross comparison and positioning which the Board is really not equipped to do on a day to day basis.

Joe T. San Agustin: You're suggesting a global mandate separate to...? Maggie Ralbovsky: That's right. In addition to U.S., EAFE and EM. Antolina Leon Guerrero: So more looking like this. Not everybody become global. Maggie Ralbovsky: That's right. So to answer your question earlier, your question was, how does that fit into our current portfolio? The current portfolio is U.S., EM and EAFE, they still exist, we add a global piece and by adding a global piece... Joe T. San Agustin: And no constraint, give a global mandate with no constraint. Maggie Ralbovsky: With constraint, a 50/50 constraint. Joe T. San Agustin: Over and above the others. Maggie Ralbovsky: That's right, but you don't constrain them to how much in EM, how much in EAFE, that's just a definition thing. Antolina Leon Guerrero: By establishing 50/50 does that mean that these managers, I mean let's say they looked globally and thought U.S. companies we should be investing to maximize our return, I want to invest in 60%. Maggie Ralbovsky: Oh sure, 50/50 meaning you have a 50/50 percent constraint for international, maximum constraint. Antolina Leon Guerrero: So if they ended up going 70/30 U.S. that's fine, that's still consistent with the global mandate? Maggie Ralbovsky: That's right. The global mandate is usually constrained of maximum non-U.S. equities. So that's this optimization, the only thing we relaxed is the global. You can see I also have a global REITS here in one of the policies in addition to the current U.S. REITS.

Antolina Leon Guerrero: The return and the risk for option C, I mean the risk is the same and the return, 10 basis points, is that a good thing? Maggie Ralbovsky: 10 basis points is huge. Antolina Leon Guerrero: Okay, I'm just asking. For somebody who doesn't do this for a living, it seems like a big deal and it's going to be hard to sell downtown. Maggie Ralbovsky: You can translate that into dollar, 10 basis points compound that, it's huge.

So as I said for this particular section we only relaxed one constraint, we did not relax the other constraints.

I would like to move to tab 3. I'll come back to tab 2, tab 2 is some additional discussion on high yield because high yield was already discussed last time. I understand a mandate from the Board meeting that I was going to provide some information on what high yield may do to the portfolio. So in this section I actually kept the equity portion and did not change the equity portion but I added high yield, you can see and I added the other categories. So, hypothetically if we included high yield and relaxed the global constraint and kept the commingled fund constraint, but commingled fund can be used for things other than the categories that's not explicitly defined in the statute. For example, strategy like risk parody, there's no way I can fit into the current statute other than using the commingled fund constraint. So if I can use commingled fund constraint into these categories rather than use that in plain vanilla non-U.S. equity I can free up a lot of risk budget in doing things that we really need to do. In that kind of perfect world what can we do with our risk budget, that's the question I'm trying to answer here.

So I did another optimization, you can see that in this optimization, the ideal policy which is the matched standard deviation policy in this table. For this policy we can move our return to 6.65% with the same risk as the current level. The current risk level is 11.18%, we can move that by instead of 10 basis point we can move this by 30 basis points by relaxing the other constraints. We can also theoretically get to the 7% return policy which is our actuarial expected return, so to get to there you have to take a little bit more risk, more than 1%, it's actually a pretty significant jump in your risk taking but you can get there.

Additionally remember we talked about the risk bucket allocation, the current bucket has 95% growth, the concentrated growth risk taking. By moving to the ideal policy we can reduce that by 10 percentage points so it will be more balanced and still improve your risk adjusted return. We can actually reduce our betting on growth being more diversified risk taking. So that's where I hope we can get to.

Antolina Leon Guerrero: Where are these pie slices credit and inflation hedge in? Maggie Ralbovsky: This is the bucket list that we talked about. Remember we talked about the bucket list in the past few times. On page 34 is the bucket list. So instead of defining risk by mathematical standard deviation we are trying to define risk in the economic factors because we know risk is changing right, so it depends on economic factors. Certain asset classes can be correlated or non-correlated, for example, bonds, okay in most standard optimization models, people assume fixed income or bonds have a positive correlation with equity to the point of point 3 because if you think about it an environment where economic growth is strong chances are interest rates are actually going to slightly go up which actually can make bonds and stocks correlate with each other. Now however, in distressed periods these correlations actually broke down, bonds become negatively correlated with stocks like today, 10 year treasury yields dropped 1.63% today, that's a 10 basis points drop on a 1.7% yield which is a huge drop and stocks went down 1.5% today, not good for the portfolio. I looked at the portfolio since April 30th, it has dropped 70 million, 75 million. The bucket list framework is trying to rationalize the different economic conditions and see if we can be more balanced. We know we have to take risk in the growth factor but can we do better without over concentrating in the growth factor, so that's the question that's trying to answer.

Gerard Cruz: Well I don't know because I guess then theoretically if you think about it, every Government in the world is trying to grow their economy. Maggie Ralbovsky: Yes, that's right. Gerard Cruz: Shouldn't we be betting on that? Maggie Ralbovsky: We should, but should we bet on 95% of it? If we can do better with 85% why would we do it, why wouldn't we bind our feet and our hands so that we cannot do it? Why do we want to do that? I really hope we can get to the ideal scenario where we change 3 things in the current statute and we can get there. Gerard Cruz: One is global mandate... One is global mandate, one is high yield which you already have done, another one is to relax the constraints for the commingled funds so the commingled funds are not treated as it's own category but rather look through it, like anything that's not included in the statute can be invested up to 30% in commingled funds, so we don't use commingled funds for international equity.

Joe T. San Agustin: We need now concrete legislation just to show and be able to justify and support it otherwise we're just beating around the bush. Antolina Leon Guerrero: So are you convinced? Joe T. San Agustin: I'm not necessarily saying I'm convinced, we have to look at legislation and see how that's going to be impacting, how it's going to be received. You need support and to show that there is a positive return for the Fund if we go this way. Maggie Ralbovsky: Well if we can be convinced they can be convinced too, so we have to be convinced first and if we don't take this first step how do we go to the next step.

I want to go to tab 2 before Franklin (Templeton) comes in and then we can have a discussion afterwards. Tab 2 remember last time we talked about high yield, the Board asked me, Gerry (Cruz) asked me the question, if we invest in high yield should we expand the current manager's mandate to include high yield or should we have high yield specific managers? I'm trying to answer that question in this section. So the first page is showing a decrease in bond allocation. The reason is this, on page 17 you can see how terrible the yield environment is right now, this is the historical yield environment for 30 year treasuries. The dark blue line is 30 year treasuries and that has dropped to 2.7% today. How bad is that? Well if you look at a 100 year history it's actually okay because we experienced that in the 1930's and we all know how bad that was. For 20 years 30 year treasuries did not pass 3% and that's the 20 year bear market we had. My point is when interest rates stay at that low level your cushion of price return, negative price return becomes so little because if you invest in 10 year treasury you get 1.7% return for the next 10 years every year, but if interest rates go up 1% you lost 5%, you lose 5% in principle, you only get 1.6% in your returns so the sensitivity has skewed to the point where your downside risk is so much more. Joe T. San Agustin: You don't have to stay at treasuries all the time, you can get out, you can get in and out. Maggie Ralbovsky: That's right. Let's look at what the other managers are doing. There are a group of managers that are called core plus managers, so there are 2 choices that we're trying to compare right now, one choice is to have our current manager say for example Franklin (Templeton), to get up to 25% in high yield bonds, up to, that's the maximum limit, that's called core plus. There are a lot of managers out there that do that. One group of managers are called core plus managers, I'm trying to define that. Another group of managers is the core manager that we're currently using and we can also add high yield managers, so we can combine our own core plus versus having a combo core plus. So these are the 2 routes, which way should we go? Joe T. San Agustin: Can current managers go into high yield? Gerard Cruz: No. Maggie Ralbovsky: They cannot. Gerard Cruz: We can ask them to, but not under our current instructions. Joe T. San Agustin: Under the current law. Not according to our investment policy. Gerard Cruz: That's correct.

Maggie Ralbovsky: Okay, page 22, can we go to page 22. Let me show you the performance of core plus managers versus high yield managers. The chart on the top is the core plus manger compared to a benchmark which is 80% core, 20% high yield, so that's a passive core plus and this is the universe comparison of this benchmark. The way you read it is that if this blue dot is above the middle line, the blue dot has beat majority of the managers, if the blue dot is below the middle line, it has been beaten by majority of the managers and you can see the blue dot is very much just in the middle which is to say majority of the time the core plus managers don't really add much value, they're sort of very much middle of the road. High yield managers on the other hand and this is the bottom, when the blue dot is below the middle line, majority of the high yield managers beat this dot, when it is above the line, majority of the high yield managers did not beat the dot. Gerard Cruz: So majority of the high yield managers have beaten the dot. Maggie Ralbovsky: Historically. Gerard Cruz: So in this case you're recommending 2 managers run 2 separate mandates. Maggie Ralbovsky: That's right. Gerard Cruz: But in a global, it's different. Maggie Ralbovsky: That's right, it is different, because high yield is an animal that takes different skill sets. If you think of a core manager, they rotate, they don't have much of a credit risk to think about. A high yield manager takes a different risk, a different skill set. A global manager is different, they have the same skill set so to speak, U.S., non-U.S. they just have to have more levers to pull. So in this case I think it's better off to have core managers than supplement it with high yield managers separately instead of having a combo manager. Antolina Leon Guerrero: Core plus is the combo? Maggie Ralbovsky: Yes, core plus is the combo.

Antolina Leon Guerrero: Which line are we looking at, the blue dots? Maggie Ralbovsky: The blue dots are the benchmark. If the blue dots are above the middle line, majority of the managers did not beat the benchmark. If the blue dot is below the middle line, majority of the managers have beaten the benchmark. Antolina Leon Guerrero: Oh, if it's below the line they've beaten the benchmark. Gerard Cruz: No, if it's below the line they have not beaten the benchmark. If it's above the line then they have beaten. Paula Blas: No, it's the other way, the opposite for the high yield. Maggie Ralbovsky: The blue dots are the benchmarks. So this is a universe comparison, if the blue dots are above the median. You can see in recent periods high yield managers haven't done well compared to the benchmark but historically majority of the time they have. The reason they haven't done well recently is because of the credit crisis. Antolina Leon Guerrero: This isn't a very good selling point to me. Gerard Cruz: I know. Antolina Leon Guerrero: I mean historically they did well but more recently, it doesn't look too good only because more recently they're not doing well, but if there is a reason, if that's assuming the credit crisis is over? Maggie Ralbovsky: No I'm not assuming that.

Gerard Cruz: If they are above the line, can we go back to the legend. If they are above this line... Maggie Ralbovsky: This is the benchmark, the benchmark is ranked more than 50th percentile, that means the benchmark has beaten majority of the managers. Gerard Cruz: So if they're above this line, then they're not doing well. Maggie Ralbovsky: If the blue dots are above the middle line, the managers aren't doing well. Gerard Cruz: Okay, so we're looking for managers who perform well under this line? Maggie Ralbovsky: No. This is the universe of the managers and the dots are the benchmark. Gerard Cruz: Okay. The dots are the benchmark. Antolina Leon Guerrero: Yes and the benchmark is beating the managers. Maggie Ralbovsky: Only for the recent periods, only for the past couple of years. Majority of the time historically high yield managers have been beating 90% of the time. Antolina Leon Guerrero: And you're saying the reason that they haven't been doing well is because? Maggie Ralbovsky: Is because of the credit crisis in different regions, therefore the market wasn't rational. Antolina Leon Guerrero: But do you think that the market is rational now? Maggie Ralbovsky: No, I think the market in the long run the market should behave rationally. Antolina Leon Guerrero: So we can expect that over the long haul... Maggie Ralbovsky: That's right. Not like the core plus managers, they're sort of forever... Antolina Leon Guerrero: On the fence.

Rosalie Bordallo: So would it be really reasonable to get into something of this nature right now in time? I mean, if the market is such that we can't figure it out... Maggie Ralbovsky: We can't do it right now, we have to change the law. Rosalie Bordallo: But that's not what we're asking. Antolina Leon Guerrero: That's not what she's asking, she's asking, okay, let's just assume that the law allowed us to do this, would this be the time for us to do it now? Maggie Ralbovsky: Okay, yes. The reason is this, because you have to compare the opportunity set with the other opportunity set and what I'm trying to make a case for is that, do you want to be in core? Look at how the risk return profile is for core, we are pricing into a pretty much depression scenario. The only time interest rate is trading at the current level is the great depression in the 1930's and the 1940's. So unless we go to that period, interest rates aren't going to go up, it's going to kill the core bond category, therefore compared to the core bond, high yield... Rosalie Bordallo: But when are interest rates going to go up? I mean right now in this environment we're looking at another year to 2 years if we're lucky. Maggie Ralbovsky: That would make our statute change perfectly in terms of timing. Rosalie Bordallo: Okay and that's what we're saying is the timing issue we're looking at. Antolina Leon Guerrero: So this is a time for us to start looking... Rosalie Bordallo: At fixing the law, but not getting in. Maggie Ralbovsky: No, I think your law is already fixed and we should get in right now, there's a 600 basis points spread out there for high yield, but that's beside the point, we can't do it anyway. If we don't change the law we can never do it.

Wilfred Leon Guerrero: If we do everything that you want us to do, what kind of return can we expect? Gerard Cruz: 6.4. Maggie Ralbovsky: No, that was just for one factor. I told you it's here in my ideal policy, it's 6.65. Joe T. San Agustin: Let's get something in front of us so we can talk to someone down at the Legislature. Maggie Ralbovsky: So does that mean we agree to that? I don't think fundamentally anybody is disagreeing with you. Wilfred Leon Guerrero: We're not arguing with you, we're trying to understand. Wilfred Aflague: I can't agree or disagree with something I don't fully understand. I've been listening to you, I haven't looked at documents or charts or anything. Can you give me the 3 recommendations that you're pushing and the corresponding assurances or conditions?

Maggie Ralbovsky: Okay, the summary of the 3 recommendations are in this book on tab 4. Number one has already been adopted during the last Board meeting which is to allow up to 25% of the equity allocation... Joe T. San Agustin: We've done that. Maggie Ralbovsky: Yes, so fixed income allocation to high yield, that has been done. Joe T. San Agustin: What is the result of that, is anything coming out of that? We implemented what you said... Maggie Ralbovsky: We have not implemented anything because we have not changed the law and we don't want to change the law piecemeal, therefore I'd like to have all 3 of these passed so we can change the law. Joe T. San Agustin: Quite frankly to be honest with you, I'm seeing all this and I'm getting confused and the more confused I am the less...

Maggie Ralbovsky: Okay, number one is to allow up to 25% into high yield, that has been approved by the Board. Number 2 is to increase the non-U.S. allocation limit... Diana Bernardo: What page is this on? Maggie Ralbovsky: There is no page number, but it says "Summary." I dimmed 2 of the bullet points because 2 were approved last time, the 2 blue ones are the ones that I'd like to get approved so then we can work on the Legislation change and the first one I want to get approved is to increase non-U.S. equity allocation up to 50% of total allocation to equity, you can say that to be 35% of the total fund. Wilfred Aflague: Can you put that recommendation down in writing with either 35 or 50, what is it that you recommend? I would like to see that in writing, don't give me 35 or 50%, give me what you're recommending. Maggie Ralbovsky: 35% of total fund, 50% of U.S. equity allocation.

Wilfred Aflague: Okay and what's your second recommendation? Maggie Ralbovsky: My second recommendation is to classify investment based on the underlying categories, therefore we can use the commingled fund for... Wilfred Aflague: I don't see that, can you work on that and give it to us? Maggie Ralbovsky: I will. Wilfred Aflague: And what's the third one? Maggie Ralbovsky: There is no third one. Wilfred Aflague: Then what assurances, I know you can't give me guarantees, but what and investment conditions that would be positive to the fund that you project? Maggie Ralbovsky: I project we're going to improve our expected return by... we're expecting an improved return from 6.4 to 6.65%, so that's 35 basis points. Wilfred Aflague: Okay. Can you put that in writing tonight? Maggie Ralbovsky: Yes, very clear, very clear. Wilfred Leon Guerrero: I think what we would like to see is a clarification of what you are recommending. Wilfred Aflague: Don't give me an optional recommendation, what are you recommending. Maggie Ralbovsky: I get it. Wilfred Aflague: Thank you. I just wanted to hear her, I think I understand. Maggie Ralbovsky: So you understand the rational? Wilfred Aflague: Yes.
(End of discussion on Investment Statutes)

<u>1:30pm-2:15pm Investment Statutes, Continued</u>

Wilfred Leon Guerrero: I think we're at that point, Bill (Aflague) was trying to summarize what it is exactly we would like to see. Maggie Ralbovsky: So I understand the wording here is very ambiguous, we need something more specific as to what exactly I'm proposing. I think there are 2 things pending, maybe I should write on that board. The first thing is to allow up to 35% of global funds to be invested in non-U.S. equities. Gerard Cruz: And this is a segregated account? Maggie Ralbovsky: That's part of the second change. Just to define investment limits based on the asset class rather than the investment vehicle. So it doesn't matter if it's a commingled fund or separate accounts. Gerard Cruz: But we're going to need to change the law that limits our investments in equity to 50%. Joe T. San Agustin: Not necessarily. She's talking about overall. Gerard Cruz: It has to be because we're 35... Paula Blas: He's right, you're going to have to do that in order to keep everybody in check. Maggie Ralbovsky: Currently you define limits by investment vehicle not by asset class, actually by investment vehicle and by asset class. Joe T. San Agustin: The law would provide for that but the investment provides what she (Maggie Ralbovsky) talks about, by asset class. Gerard Cruz: No, first we have to change the law... Maggie Ralbovsky: The law says... He's right. Joe T. San Agustin: I'm one step ahead of you. In terms of legislation I would prefer it that way and then I would go by investment policy to give us some discretion as to... Antolina Leon Guerrero: Who creates the investment policy, is it by law or the Board? Paula Blas: It's in compliance with the law. Gerard Cruz: The reason why the policy is written as it is, is to get around that 50% limitation so if you changed the definition then we're going to be in violation of our existing law. Maggie Ralbovsky: Gerry (Cruz) is right because you define the current limits not only by asset class but also by investment vehicle. So that is very, very confusing. Just because a security is in the fund doesn't make that security more eligible than if the same security is in a separate account, that makes no sense at all. The second thing is related to that.

This is obviously subject to discussion but the purpose for this is connected to what Gerry (Cruz) just raised as the issue of definition of investment not by category but rather by investment vehicle. So I wanted to use the 30% current limit not for an index fund, not for something that's already otherwise allowed but rather for things that aren't defined. Gerard Cruz: As other categories. Maggie Ralbovsky: Right, exactly. So investments in commingled funds unless otherwise allowed by other sections of statute shall be given 30%. So for example, the index fund right now is using up this 30% limit which makes no sense because the Russell 1000 Index Fund is otherwise allowed as a U.S. equity. I want to free up that limit. I want to change the definition of the limits. I want these to be mutually exclusive, so if something is a non-U.S. equity, it doesn't matter how you invest that, even if you invest this 35% in non-U.S. equity including commingled funds, it is still counted under this limit, right now it's under both limits. Rosalie Bordallo: Right now it's under 2, that's how we're getting around the limit, to go under 2 only. Antolina Leon Guerrero: You're saying only 2 applies right now? Rosalie Bordallo: Right, 2 applies for emerging markets... Gerard Cruz: Mutual funds is its own category. Rosalie Bordallo: Right, because you know we have the 15% on foreign so we know we're over the 15% and we're doing that through the use of 2. I understand what you're trying to get at here, it's just move them out and make your limit bigger for the foreign so you can just move out those commingled funds and put them in that... Maggie Ralbovsky: Exactly. Paula Blas: And then that way you free up your 30%.

Maggie Ralbovsky: We already did the 25% in high yield, that's up to 25% of fixed income allocation. Joe T. San Agustin: What is the allocation of fixed income right now? Maggie Ralbovsky: Right now it's 30%. So these are the 3 things. Gerard Cruz: What is the third one? Maggie Ralbovsky: The third one is the high yield. Joe T. San Agustin: I think you're going to have trouble with number 2. Paula Blas: Number 2 is already there. Joe T. San Agustin: So why bother, why repeat it? Maggie Ralbovsky: No, it is not a... Paula Blas: You already have a limit of 30% in commingled. Joe T. San Agustin: It's already in the law that allows it right? Maggie Ralbovsky: No. Paula Blas: Really what she's trying to do right now is increase your limit in international from 15 to 35 for non-U.S. Joe T. San Agustin: Why don't you say invest in commingled mutual funds, forget about the rest. Maggie

Ralbovsky: No, I cannot do that because right now the definition of commingled fund as if it's an asset class, it is not, it is an investment vehicle. Paula Blas: Didn't we just amend that? Gerard Cruz: Yes.

Wilfred Leon Guerrero: Here is the thing, if we go 100% with what you want, tell me again what kind of return we can expect? Maggie Ralbovsky: With the same risk you can move your return from 6.3 to 6.65, but also if you want to get to 7% which is the actuarial expected return with the current constraint you can never get there. I ran the optimization, you can never get there because of the constraint, 7% is an unreachable goal. Rosalie Bordallo: But isn't this based on expected market returns your 6.65, so to say that you can never get to 7%, if for some reason the market acts in a way that you do get the return, you can get the return only if the market doesn't act in the way you've plotted it to act. Maggie Ralbovsky: Of course. Rosalie Bordallo: So you can't say that you can never get that return. Maggie Ralbovsky: No, I'm obviously framing in a way to say that with our expectation you can never get to a 7% return, but by relaxing the constraint you can, the efficient frontier is moved to this way, you can actually at some point reach the 7% return. The problem right now is that you are on this efficient frontier, you can't get better. It makes no sense to constrain yourself that way, I don't understand. Joe T. San Agustin: What's the rational of having a 7% actuarial assumption there? Maggie Ralbovsky: So the Government of Guam doesn't have to spend 50% into contributions. Isn't that an essential issue? Rosalie Bordallo: No, it was built on the fact the expected returns when it was approved was higher and you went conservative, but now the market expectations are lower. Paula Blas: When they first made the recommendation for this they showed us that the expected rate of return was below 7%, it was like a little below 7%, 6.8 something, but we said keep it at 7 and so far it's been good. Maggie Ralbovsky: For the past 10 years it didn't reach 7 and for the next 10 years it's not expected to.

Joe T. San Agustin: If you set up a 7% return as our actuarial assumption based on the fact that that is the amount of money that we need to do to sustain the Fund and keep the contributions affordable, if we can never reach that 7% then we're making up the shortage someplace else because our obligation continues to rise. Maggie Ralbovsky: Therefore you need to change your statute so you can have a chance to reach 7%. Joe T. San Agustin: That's what I'm saying, what's the sense of having 7% if you can never hope to reach it? Maggie Ralbovsky: So we can explain to the Legislature, okay, you can tie your hands and never reach 7% and increase the contribution rate or you can cut the wire and untie your hands and get a chance to reach 7%.

Wilfred Leon Guerrero: I'm all in favor of this flexibility, but can you explain, for the quarter the return was 9.66 and you're saying that we can never get 7%? Maggie Ralbovsky: For the past 10 years you never reached 7%, you have to look at the long term. Wilfred Leon Guerrero: What is that chart behind you? Rosalie Bordallo: On average. Maggie Ralbovsky: On average is not annualized return. Annualized return was 6.4%. Joe T. San Agustin: And that's because of the law that constraints us from reaching 7%. Rosalie Bordallo: That's because of the bad market in the last 4 or 5 years. If we didn't have that period you would have made the average, you would have made the 7%. Joe T. San Agustin: Despite the fact that even if the markets can do good, because we tied our hands we could never reach it. I couldn't reach that even if I wanted to because my hands are tied, that's what you're saying. Rosalie Bordallo: I disagree with that. What's she's (Rosalie Bordallo) saying is that past backward looking. She's right. Backward looking because 10 years ago you had the chance probably to reach 7% if the past 10 years didn't happen the way it did. Rosalie Bordallo: The last 5 years.

Joe T. San Agustin: When was the last time we changed our assumption rate? It was lower than that. Gerard Cruz: 2003. Rosalie Bordallo: It was higher. Paula Blas: It was 7.5. Wilfred Leon Guerrero: I still don't understand, you're saying we can never reach that 7%. Maggie Ralbovsky: What I'm saying is that on expected cases you have to do an optimization. You understand efficient frontier? Efficient frontier is to combine all the opportunity sets that you are allowed to do, combine all these asset classes, because there are so many ways you can invest your assets let's say the expected return for ever level of risk is unlimited, but given the constraint there is a best choice for every risk level. (This is risk and this is return). If you summarize your best possible combination with the constraint you come to something called the efficient frontier which is the best return you can get for every level of risk. The efficient frontier shifts if you change the constraint. With the current constraint in the statute this line can never cross 7%. Wilfred Leon Guerrero: Every time you make that statement I just don't understand you. Maggie Ralbovsky: Why don't you understand that? Wilfred Leon Guerrero: Because this quarter the return was 9.66%. Maggie Ralbovsky: That's just one quarter. The market rhythm goes up and down, what you want is a long term return, you're not living one quarter and this particular current quarter, this... Wilfred Leon Guerrero: But when you make the statement we can never get this, we just did. Maggie Ralbovsky: This is a long term expected return. Wilfred Leon Guerrero: So what are we talking about average or what? Rosalie Bordallo: No, annualized. You take all those years with the up and down and then when you smooth it out, you cannot reach 7%. You might make 20 here but you make a negative 10 here but overall when you smooth it out it will not hit 7. Antolina Leon Guerrero: And the actuary is basing our ability to fully fund the pension based on 7% but if we're never going to reach that overall, we're always going to be short, we're going to end up short. Gerard Cruz: But even if we don't touch the actuarial rate of return to shift us to a point to meet the 7% it's going to require a change in our strategic allocation. Maggie Ralbovsky: Yes. Gerard Cruz: But that changing the allocation to an accepted return of 7% is increasing our risk level to 12. Maggie Ralbovsky: Yes, correct. But the point is you can't even get there. Gerard Cruz: I'm not disputing, I'm just saying by just chasing return, I think we still need to address the actuarial rate of return.

Joe T. San Agustin: The selling point of this legislation is to say you're not going to increase your contribution rate. Gerard Cruz: I don't know if we can say that though because the contribution rate is based on many things. Maggie Ralbovsky: I think the point is right now you have your hands tied. Gerard Cruz: We're going to need to change the amount that we can invest in equity before we change the amount of equity that we can invest in non-U.S. securities. Maggie Ralbovsky: Not necessarily. Gerard Cruz: So we can still have our total equity investment of 50%? Maggie Ralbovsky: No. To answer your other question, yes. I was confused. To answer your question, he is right by saying we have to change that definition of... Gerard Cruz: The limitation. Maggie Ralbovsky: Yes, separate account versus commingled fund because being separate asset classes, that's not the right way.

Joe T. San Agustin: Start putting it in legislation form and see how it works. Gerard Cruz: So we have to get it past the Board then. Joe T. San Agustin: But the selling point is, what would this do to their contribution rate. Gerard Cruz: I understand. Joe T. San Agustin:

We have to lessen their contribution because... Gerard Cruz: But see I don't know because if we're going to chase the 7% rate and agree to a higher level of risk then there's going to be months of volatility or years of volatility when the contribution rate because of a negative return could in fact go up.

Wilfred Leon Guerrero: Okay, we're going to change the discussion now. Those are the 2 items. Gerard Cruz: But that doesn't work unless you change the total allocation towards equity, the total unless you increase the limit. Maggie Ralbovsky: So does that address your concern? If not, we need to change the language. Gerard Cruz: You can pass those 2 but we're still going to be constrained with the amount of money that we can invest in equity, even if those 2 pieces of legislation pass. How do you get beyond 50% equity, we'll still be constrained with 50% equity. Maggie Ralbovsky: That's right. Wilfred Leon Guerrero: Can we hold that discussion because Bill (Aflague) has to leave and we have this bond proceed that we need to talk about.
(End of discussion on Investment Statutes, Continued)

<u>Asset Allocation</u>

Maggie Ralbovsky: We need to rebalance the total Fund because right now the REITS allocation is bumping to the maximum allocation limit. I have a spreadsheet made out which I have on my computer, to take some money out of REITS and adding the $16 million we're going to get from the bond proceeds to allocate that to international equity. Paula Blas: It's 24 for payroll, we wanted her (Maggie Ralbovsky) to put the rest of it out there. Maggie Ralbovsky: So there is a $16 million dollar inflow and there is a need to take 19 from REITS, a total of $35 million and the $35 million needs to go into international, mainly the small cap, DFA and Capital, $20 million to DFA and $15 million to Capital. Of the $19 million, Cornerstone $9 million and Security $10 million. Paula Blas: We're taking it from REITS because they're close to the maximum. Gerard Cruz: This is from market gains? Rosalie Bordallo: Yes. Maggie Ralbovsky: REITS out performed this year. Diana Bernardo: I just want to make a note, the proceeds are approximately a little over $24 million and we want to keep $8 million for operations. Next week we expect to take $3.5 to $4 million out of REITS for the June 15th payroll, but the additional $8 million we want to keep for the following pay period.

Gerard Cruz: So we're ready to hear where the allocation is going. Maggie Ralbovsky: $20 million to DFA, $15 million to Capital. Gerard Cruz: Start with the withdrawals. Maggie Ralbovsky: We're pulling $9 million from Cornerstone and $10 million from Security Capital. Wilfred Leon Guerrero: Okay, so we all understand each other, we're taking $9 million from Cornerstone, $10 million from Security Capital and then the proceed is $24 million, that gives us $43 million. Maggie Ralbovsky: Minus $8 million. Wilfred Leon Guerrero: That leaves us $35 million and that goes $20 million to DFA and $15 million for Capital International. Joe T. San Agustin: I'm assuming all those monies are going to be at a capital gain. Gerard Cruz: Yes. Joe T. San Agustin: That would be a condition to me because it doesn't make sense to take something out and lose it and then have monies that the Retirement Fund is getting from the bond and then swap. The swap is not going to be a negative swap, it has to be a capital gain, I'm not going to support anything that has a capital loss. There has to be a capital gain to offset the opportunity loss. You're getting money from the bond proceed already, why take money out to substitute? Maggie Ralbovsky: It's not substitute, it's rebalancing. It is a capital gain.

Diana Bernardo: What about MetWest? They're over by about $18 million, are you going to leave it alone? Maggie Ralbovsky: Yes. The next time you withdraw money, you withdraw from MetWest. I don't want to make this too complicated. Diana Bernardo: I just want to make sure we address that. Maggie Ralbovsky: The total category of U.S. equity is not way over weighted, it's just MetWest is. I'm hoping next time you take money out of the Fund, take it from MetWest, but right now we don't want to get it too complicated. Joe T. San Agustin: These people are over allocated by $24 million dollars. Gerard Cruz: Yes, because of gain, they out performed. Joe T. San Agustin: How much is actually a capital gain? Gerard Cruz: The whole thing is capital gain. They made a lot of money, they are good managers and we got in at the right time.
(End of tape 1)
(End of discussion on asset allocation)

Respectfully submitted,

SMLimtiaco

STEPHANIE A.H. LIMTIACO
Recording Secretary

Affirmed:

WILFRED P. LEON GUERRERO, Ed.D.
Investment Committee Chairman