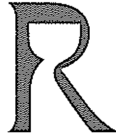

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Quarter Ended 12/31/11 Performance Meetings

January 26, 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, Member
Antolina S. Leon Guerrero, Member
George A. Santos, Member

Staff Present:
Paula M. Blas, Director
Diana Bernardo, Controller

Other Present:
Terry Dennison, Mercer Investment Consulting Inc.
Alice Taijeron, Great West
Doris Flores-Brooks, Office of the Public Auditor

Economic & Capital Market Environment pages 1-17
DC Plan Performance pages 17-25

10:00am DC Plan

Economic & Capital Market Environment

Terry Dennison: A lot of this discussion is going to be about debt, because debt really is the primary issue and if you turn to page 25 and now flip the page and then the next page, I'm going to give you a bit of scale. We're going to talk a little about debt and just to give you a sense of scale, if you turn to the next page we have a picture here of a $100 dollar bill and the point of this, we're going to walk through here and show you what a trillion dollars looks like because people throw around

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$1 trillion dollars like it's just some other number. A packet of $100 dollar bills which is $10,000 dollars which would give you a couple of great weeks in Las Vegas, would fit in your coat pocket. If you turn the page, $1 million dollars would fit in a brief case, a knapsack or in a grocery bag. $100 million dollars which is getting to be a fair amount of money, that would fit on a standard pallet, so $100 million dollars in $100 dollar bills fits on a pallet.

Now turn to the next page $1 billion dollars in $100 dollar bills, it is 10 pallets. The next page as it says, ladies and gentlemen I give you $1 trillion dollars. That's a double stack of pallets of $100 dollar bills and each pallet has $100 million dollars in it. The little red figure over here is the person, so to the lower left hand side to what looks like a red line, that's a man.

The U.S. national debt which we talk about as being $14 trillion dollars, turn to the next page. Doris Flores-Brooks: Isn't it over almost 15? Terry Dennison: It's almost $15 trillion dollars. This gives you a sense, we have a scale of what $15 trillion dollars looks like. Doris Flores-Brooks: This is 15? Terry Dennison: It's actually $14 trillion dollars. Now where does this end? Turn to the next page, this is where it ends. That is an actual $100 trillion dollar note from Zimbabwe, it's worthless but it's a very handsome bill, it's got a watermark, it's got African animals on it, I paid 5 pounds for it. Joe T. San Agustin: This does exit? Terry Dennison: Yes, but it's worthless, I bought it for 5 pounds, 5 British pounds, $8 U.S. dollars. At the time that was circulated in Zimbabwe you could probably buy a loaf of bread with it if you did it in the next couple of days because that bill became worthless in a matter of a couple of days.

The last slide here is a graffito in London from a famous graffiti artist named Banksy, really talking about basically what's going to happen when everything goes to hell. I just wanted to give you a sense of scale. Doris Flores-Brooks: The way congress talks about it, it's no big deal. Terry Dennison: Right.

If any of you would like electronic copies of this, I can give you electronic copies of this. I did enjoy that cartoon because that's where we're heading. Doris Flores-Brooks: If I can just interject because yesterday at AGA we had Jason Miyashita speak and I was quite impressed with him, he is an investment advisor and he started off with a YouTube video, it was so funny, it was about how 5 and 5 is 25 but the other said 5 and 5 is 14 and it goes through this, but you will laugh because it's the way you add things that you can get a different number, how you can you add 14, 14, 14, 14, 14 to give you a different number, you add 4, 4, 4, 4, 4 and then 1, 2, 3, 4 5 it's 25. What it really brings home is the math is important because the message is how people sell you a bill of goods you're going to get X but it's really Y and that was really the thing and it's a very good video to just bring home what you think you got, you got something else.

Let's go back to page 2 and talk about what happened in 2011. It was certainly a volatile year and frankly we're going to look back fondly on 2011 because 2012 is going to be much worse. The reality is the uncertainties in Japan or in Europe and the issue with the U.S. economy which we'll get into, all of this is very negative. The best place to invest in the stock markets was in the U.S., the S&P 500 was actually up 2.1%, everything else was very poor. The Russell 2000, the small cap U.S. fell 4.2%, the EAFE Index was down 12.1% and the emerging market index was down 18.5% so it was a tough place. It doesn't look a lot better, the outlook for global growth is very weak, in fact I saw today that the international monetary fund has reduced their forecast for 2012 global growth down to 1.4%. Interestingly Dr.

Bernanke said that the Fed is now going to keep interest rates low now through the end of 2014 which means they're forecasting that we're not going to have any good economic times until 2015, we're talking about 3 years of recession or no growth. So all of these problems are unlikely going to be solved in the short term, volatility is going to stay high, uncertainty is going to stay high.

One of the things that maybe was a silver lining and this is sort of an ironic statement, given how much risky assets declined, they're probably going to be pretty good values now. In fact you'll see some statements here instead of just an overview of what happened we actually put recommendations in this report and one of the recommendations is for an aggressive investor European stocks unless the bottom completely falls out probably represent a pretty good value because they've been beaten down so much that from a valuation perspective they look attractive. We do think high quality companies, companies with good earnings, strong balance sheets, dividends paying in stable businesses like consumer staples are probably the place to invest. It's not a good time to be investing in speculative asset classes.

The recent poor performance in emerging markets also probably gives you a good entry point if you want to invest more in emerging markets because they have dropped so much. The emerging markets where previously the saying was when the developed world got a cold the emerging markets got pneumonia, now it's probably more the other way around, but clearly if we do see a decline in business activity in Europe, it's going to have a negative impact. China exports about 20% of it exports to Europe so if Europe stops spending that's going to have an impact even on China. Joe T. San Agustin: What they're doing now is China is going to hold back. Terry Dennison: China is trying to slow down, the question is, it's very difficult to have what's called economics of soft landing. Basically they've had a huge property bubble and it's very difficult because a lot of the provinces and cities have gotten significant amount of their revenue from selling land and the ownership of that land is actually in dispute because they're selling peasants land to developers to build cities that nobody lives in, but there's going to be some significant stress there social and political possibly, certainly economic as China slows down. There was an article in the Economists magazine a couple of months ago that a lot of companies that are more export oriented in the Shenzhen type zone are cutting back people's hours or just arbitrarily cutting their pay because don't export as much as they do.

If you turn to page 3 you can see in the upper left hand corner it's been a tough year for equity markets. Again that blue line on the top is the S&P 500 and in the upper right hand corner you can see that basically everything else in the world went to hell other than the S&P 500. The S&P 500 is largely although not exclusively these kinds of quality companies, large, multi product, strong balance sheets so you can see the benefit of investing in quality stocks. If you go to the lower left hand corner, the economic sectors you can see the sectors that did the best are the defensive. The best performing sectors in 2011, utilities, consumer staples, healthcare, the one's that are the most defensive the companies that basically get business as long as anybody has any money. The poorest performers, financials and its outstanding figure, financial stocks declined 16.9% per year over the last 5 years, if you un-annualize that number they're probably down about 90%. Financial stocks have just been completely wiped out. Materials and industrials also economically sensitive, so basically despite the fact toward the end we saw a modest decline in unemployment and a bit of a pick up in gross domestic product, the economy was really very weak in 2011.

Wilfred Leon Guerrero: Can we go back to page 2, this is just something I'm hearing on TV, you're saying that the hedge fund investors had a disappointing year. Terry Dennison: Yes, very. Wilfred Leon Guerrero: How could Romney make money? His business is not hedge fund, it's private equity, basically either venture capital or leverage buyouts. The Bain company that he was a principle of is not hedge fund, it's really a company that either establishes new companies grows them and takes them public or buys existing companies with poor management or poor balance sheets and fixes them up and sells them, so it's a completely different sort of thing. There actually is a page in here about private equity that I wasn't intending on talking about but I certainly can, but that's how he got his $200 million dollars. Wilfred Leon Guerrero: I was under the impression that hedge funds and private equity are the same. Terry Dennison: No, hedge funds are completely different. Hedge funds, there is no asset class called hedge fund, hedge fund is an investment fund technique hedge fund managers buy and sell stocks, buy and sell bonds but they do it with leverage, they do it with a lot of more exotic techniques. The thing that's difficult to understand about hedge funds is they're not really an asset class, it's not like a bond or a stock or a private equity or some type of asset, it's a way of running money and in fact it's often simply called a compensation system because the fees for hedge funds are very different from the fees that you pay for... Joe T. San Agustin: You buy and sell, margins... Terry Dennison: They're leveraging, they'll try to find a little gain and borrow 10 times as much money so that you can make a little gain into a big gain. Now the problem is if you have a little loss it makes into a big loss. So hedge funds the good ones are very good but only about a 10% of the hedge funds are very good, 90% of them stink.

Page 4 realistically if you look at performance for the year which is the right hand panel it was all fixed income and in fact treasury inflation protected securities were the best places to invest. Interestingly the DC Plan has a TIPS fund and if you look at the TIPS fund, that was pretty good. U.S. treasuries again because rates continue to fall, one of the questions is why are rates falling so much and one of the answers is frankly U.S. treasuries are about not only a some what risk-less asset, the other available risk-less assets are shrinking. If you look at French bonds, they're not considered risk-less anymore, even German bunds aren't quite as risk-less as they use to be, so realistically U.S. treasuries have done well because they're one of a shrinking number of securities that people generally consider to be risk-less, but at this point rates look like they're going to stay low for years to come and in my mind that tells me the Fed thinks we're going to have very difficult economic times for the next 3 years.

If we turn to page 5, clearly what's driving a lot of these concerns is what's going on in the Eurozone. I think it's important to understand what is the driver of the problem in the Eurozone, clearly countries like Greece and Portugal and Italy have run their economies very poorly, as soon as they became part of the Euro they were allowed to effectively borrow at German interest rates and they discovered the marvels of buying on credit and they just ran up huge credit balances which now clearly they can't pay, but that's not the real problem, the real problem is productivity, these economies are 30% less productive than Germany. Gerard Cruz: That's always been a problem. Terry Dennison: It's always been a problem but it worked before because they could simply de-value. I mean if the Greek economy was not competitive with the Germans, they de-valued the drachma and made themselves competitive. The fundamental flaw of the Euro is it allowed countries who were not as productive to be yoked together with countries that are and that's the central problem and people in the Euro set up said that. Norman Lamont who is a former Chancellor of the Exchequer of the UK said, this can't possibly ever work, it will be just a matter of time before it blows up and realistically they keep putting band-aids on it and they keep having these

great summits to deal with it and what's interesting is the summit use to keep things calm for 2 months, then for 2 weeks, then for 2 days and now they don't keep them from blowing up at all. We now have the situation with Greece where they now look like they're simply going to default in March because they can't make a deal with the private lenders and the IMF won't give them money unless they make a deal so it looks like we're now going to head over the cliff and find out what really happens. Doris Flores-Brooks: In some respect isn't that good? Terry Dennison: That's good. Doris Flores-Brooks: The survival of the fittest and you move on, I mean that's the natural evolution of things, countries come and go. Terry Dennison: I think it's good partly as an object lesson for other very indebted countries including this one. Doris Flores-Brooks: This is a wake up because everyone says we're not Greece. Terry Dennison: We'll talk a little bit about the U.S. situation and just to remind you that when we talk about it, you can't do away with yourself by just jumping out of the windows, this is a ground floor room. You will probably be alarmed with what I'm going to talk about, but clearly the situation there now has gone beyond the la dolce vita countries in the south, it's now even impacting France, it's impacting other countries.

Doris Flores-Brooks: What's going to happen to the PIGS? Terry Dennison: Well I think realistically it will be a domino effect. The Irish are a little different situation, the Irish which had a huge property bubble which just got to ridiculous levels. I saw an article that basically a property developer in Dublin bought a city dump for 450 million Euros to build houses and that land is now worth -30 million Euros because they have to clean it up, so people just got ridiculous. I told you the story about the cars in the Dublin parking lot from all the Polish workers who just abandoned their cars and went back to Poland, it just got absurd. The level of debt banks like Anglo Irish ran up if you translated it to U.S. terms it was a much bigger disaster than Bank of America or JP Morgan Chase because they basically ran up, they lost $3 billion dollars in an economy about the 10th or 20th the size of ours.

Now actually the worst situation which didn't get much press was in Iceland. Everybody in Iceland decided they didn't want to fish anymore, they all became investment bankers and the best story I heard about how the banks in Iceland sort of got into this trouble was this, you have 2 people, one has a dog and the other has a cat and the person who has the dog sells the other person the dog for a billion dollars and then the person who has the cat sells that to the person who has the dog for a billion dollars and now each has a billion dollars in assets, they're no longer pet owners, they're Icelandic banks. So that was just the canary in the coalmine but I think realistically the level of austerity that's going to be necessary to fix these problems is impossible in a democratic society. If you read about conditions in Greece it's just tragic and they're not even close to being able to deal with their problems, the best thing for everybody is they default. There have been a lot of scarce stories, it will be the end of the world, but realistically every bank has already figured out what the losses are going to be and they're going to protect the system. It's better to just let it go, the old observation a horrible ending is better than horrors without end, particularly if there is no real horrible ending. Doris Flores-Brooks: So you think that's what is going to happen? Terry Dennison: Yes. Gerard Cruz: There has been sovereign debt default all the time. Terry Dennison: Greece has defaulted like 5 times in the last century, this goes on all the time.

The banking system is obviously very inter-related because the banks said, all the Euro credits are the same so the issue is going to be in the French banks and to some degree the German banks. The U.S. banks are largely out of this, U.S. banks had a very unhealthy appetite for short term European credits like short term bank notes because they were used in American money market funds because American short term debt yielded next to nothing

and the only way they could offer a decent yield in the money market fund is to buy European bank debt, but they've now pretty much bailed out of that, in fact I saw a statistic, I have some notes, which is really scary stuff, the French banks lost $400 billion dollars in funding in a couple of months because of just money flowing out of money market funds.

So we're going to get back to the Euro crisis but let's keep going because it's... Gerard Cruz: We're going to get back to the Euro crisis? Terry Dennison: Oh yes, there's more in here. We're doing this in 2 pieces, we're doing the standard book and then I have my views.

U.S. economy 3rd quarter GDP growth was 1.8%, we're probably looking at 3% rate in the 4th quarter. The 4th quarter was pretty good (I'm on page 7) unemployment came down but the reality is there's something a little bit artificial about that, we still have the benefit of the weak dollar benefiting our exports, industrial production was still fairly high and consumers basically went on a bit of a spending spree, now they financed that spending spree by cutting their savings rate and you can look at the statistics and see that the savings rate which has gotten about as high as 5% fell substantially. The graph on page 7 on the lower right gives you a sense of what's happened with the savings rate, well that's obviously limited, it can't fall below zero and consumer credit is still very scarce for everybody but the wealthiest so the reality is they're no longer able to use their home as an ATM, credit is hard to get, credit limits have been cut back, underwriting is much tougher. We probably had a bit of a blip and I think it's going to be interesting to see once we start to get a sense of first quarter performance, but you see the note on the bottom bullet on page 7, recession remains a risk, we could slip back into recession, growth isn't very robust, it depends a lot on consumer growth. It's interesting that the dollar has been slipping again, the Euro is over $1.31 and unemployment is still an issue, while the rate fell to 8.5%, much of that was from people leaving the labor force, the labor force participation, the percentage of working age adults who are working or looking for work is at a very low level.

If you turn to page in the upper left hand corner, that brown line is the U6 statistic and the U6 statistic from the Department of Labor is people who are looking for work or are involuntarily working part time and you can see that it got well above 16%, pushing 17% and is now just dipped below 16%. So about a 7th of the labor force in the U.S. is unemployed and if you look at labor force participation, (which isn't on this chart) it historically has been in the mid 60's and it's now about 57%. Now clearly people who are near retirement age are basically saying, I'm done, I can't get a job so I'm just going to stop working, if they can.

Another factor that's been very difficult on the economy is in the lower left hand corner, real wage growth has almost been zero. Salary income has been relatively flat, because with huge unemployment there is no need to bid up wages. If we look in the lower right hand corner at leading economic indicators after a pretty good blip up now they slip back to being negative, so it looks like the U.S. economy has been a bit weaker. The scariest one is in the upper right hand corner, this is employment losses compared to past recessions and what we did here is we looked at what the peak of the recession was, what was the worst quarter of recession and each one of those lines represents one of the post World War II recessions and we start them all at zero and see how long it takes to get back to full employment and you can see if you look at 81/82 which is the yellow line, yes we saw unemployment dip, unemployment rise, but it rebounded very quickly. If you look at the 73/74 which was a pretty tough recession, that was the second year I was working in the investment business, a pretty tough recession, basically unemployment or employment, depending on how you look at it, was back within 3 years or actually in a year and a half. Look at the brown line, that's

this recession, we're not even close to getting back to the employment level we had and it's just now turning up, we're 50 months into the recession and we're still substantially below the peak employment before the recession and just barely trending up. We've only covered about a third of the jobs that were lost in the great recession and have a weak, weak outlook ahead of us.

We talked about the global economy, again world economic growth is expected to decline, the emerging markets and their consumers which were previously seen as their replacement for the U.S. consumers, the driver of global growth are also struggling. In Europe, the official forecast for Europe for 2012 is a decline of growth of about a half a percent, most real economists say it's at least 2% down which is still a fairly mild recession and clearly if the developed world stopped spending money it's going to stop buying or certainly reduce buying of products that were produced in the developing world of the emerging markets.

To give you a sense of just how powerful Germany is, look at the lower left hand box, this is the percentage of GDP that is from exports, nearly half of German GDP comes from exports because Germany is really the workshop of the world. We've heard the U.S. economy being hollowed out, that we use to make things now we make paper, well that's about it, we get less than 13% of our GDP from exports, we don't make anything anymore. Doris Flores-Brooks: What does Germany export? Terry Dennison: Machine tools, cars, sophisticated electrical equipment, trains, lots of things. We don't make anything anymore and that's part of the problem. Doris Flores-Brooks: I'm surprised like compared to Japan because when you think of cars you think of Japan you don't think of Germany other than the BMW. Terry Dennison: The BMW, the Mercedes, Audi. It's mostly machinery, the stuff you wouldn't buy. If you're buying machine tools or you're building a factory that needs machine tools, that's where you get it from.

The dollar rebounded on page 10. To some degree it wasn't a signal of strength, but remember the U.S. was downgraded to below investment grade, it didn't really affect even our funding costs or the market's perception of our economy but the reality is it probably rose to 2011 because it was the least banned currency. Some strong currencies like the Swiss Frank had to institute defenses because money was flowing into Switzerland at such a rate it was beginning to distort their economy and cause the Swiss Frank to rise so much that is was impacting their exports.

There was an interesting chart in the Economist Magazine about 2 months ago that showed the increase in the amount in 500 Euro notes in circulation. A 500 Euro note is worth about $700 dollars, so it's a little piece of paper that's worth nearly $1,000 U.S. dollars and the volume of 500 Euro notes has increased dramatically. Doris Flores-Brooks: Why? Terry Dennison: Because if you're going to take your money across the Alps in a knapsack, you want it to be as small as possible. You're now seeing literally flight capital, people just getting their money out of Greek banks, literally the Greek banks are losing at an un-survivable rate, they're totally unable to fund themselves now, they're just creatures to the European Central Bank, but basically now you're just seeing fight capital. People don't even trust the Euro anymore they want to get the money into Switzerland and get it into Swiss Franks and it's driving up the value of the Swiss Frank to a level that was beginning to negatively impact our exports.

Talking on page 11, the headline says it all, "rates are absurdly low, but likely to stay that way," and of course this now you can say is even out of date because the Fed has extended

their low rate commitment all the way to the end of 2014 which is a very long way away. Doris Flores-Brooks: For them to come out for such a long time. Terry Dennison: Yes. Basically Dr. Bernanke said the serious concerns about unemployment, their sense is they're not going to have to reign in inflation because of excessive growth for a very long time. Headline inflation, inflation is what's going to be what happens when debt becomes un-survivable, that was the 100 trillion dollar Zimbabwe note. Headline inflation is running over 3% but that's largely driven by energy prices, core inflation is still fairly low at about 2.2%, but if wage growth is 1 or 1.5% what that means is real wage growth is negative. When the consumer feels squeezed, they're squeezed because real wages are falling, real household income is falling because even though inflation is low, incomes are at an even lower rate of growth.

On page 13 looking at financial markets, when we talk about macro factors, macro factors mean sort of big economic things, what's going on with debt, what's going on with the Eurozone, volatility and if you look at the upper right hand corner, you're looking at the global implied volatility. You saw a huge spike obviously in April of 2011, but basically volatility is still above historical levels. Volatility which is kind of a measure of risk or a measure of uncertainty, you can basically say if you think about the gauge that measures greed or fear, As VIX goes up the meter is going over toward the fear line so basically the fear in the market continues high. Again, the European Central Bank is now handing out money left and right. It's important to understand that because there was basically a short squeeze on U.S. dollars, the banks had U.S. dollar liabilities and couldn't get any dollars, the Federal Reserve opened what's called a swap line that allowed European banks to borrow U.S. dollars from the Fed. Those really aren't what's called sterilized, so in effect that's increasing the U.S. money supply. I have an interesting comment here that I'm sure will get the Chairman revved up, it was in the Wall Street Journal on the 28th of December from Gerald O'Driscoll who is a former head of the Dallas Federal Reserve Bank talking about this Fed swap line, made 3 comments, "the Fed has no authority to bail out Europe." "It's a moral hazard." Moral hazard means if you allow people to just not pay their debts, why pay their debts. And finally, "it's non-transparent and is troublesome in a democracy." So basically the Fed has now jumped in an increased the U.S. money supply in order to bail out the European banks. Joe T. San Agustin: Why would they do that? Terry Dennison: Why would they do that? There is a good systematic reason for doing it; if the European banks all fail it's probably not going to be good for the U.S. At the end of the day, the role of the Central Bank is to protect the system, it's the banker's bank and it's to protect the system. The system is now so under threat that they felt that they better make sure that there's not such a squeeze on the availability of the dollars in the banks in Europe that could cause them to tip over. There were stories that at least one German bank, probably Commerce Bank was in days of failing. This is the second biggest bank after Deutsche Bank in Germany. It was in days of failing because they had dollar liabilities and couldn't get any dollars, nobody would give them any money.

In the bold statements here are some forecasts in our view. We think high quality credit, this is not the time to go trolling in high yield bonds, high quality credit as opposed to treasuries is attractive. Treasury yields are so low that high quality corporate debt is an attractive investment. We again have a bias where it's low volatility, high quality equity strategies because they give it some downside protection, this again is quality companies in stable industries like consumer staples, strong dip balance sheets, dividend paying. One of the things and we'll get into that about the European banks, they are having to raise capital to meet Basel III capital standards and of course this is a horrible time to be trying to raise

capital so literally the banks are destroying the governments and the governments are destroying the banks in Europe because they're having to stop loans, call in assets, sell assets to meet these capital requirements which is exactly the wrong thing to stimulate the economies, so the banks now are doing in the economies. We'll spend some more time on this. Gerard Cruz: But that's worldwide. Terry Dennison: That's worldwide although it's much worse in Europe.

One of the interesting statistics that I drug up was the scale of European banks. Europe is very dependent on its banks. In the U.S. commercial and industrial loans from banks are $1.1 trillion dollars. Corporate bonds that were issued by U.S. companies is $4.8 trillion dollars. In Europe commercial and industrial are $4.8 trillion dollars and bonded debt is $1.2 trillion dollars. So basically if the banks go down, the companies go down. Realistically American companies don't make much use of bank debt. Gerard Cruz: American companies, because of capital market. Terry Dennison: Because of capital markets, but they're really aren't good capital markets in Europe, but basically for hundreds of years going back to the Rothchilds and the middle ages it's been the banks that have been financing European companies. When the banks get in trouble or when the banks have to stop lending because they have to raise capital, that puts the financial position of the European companies in great jeopardy.

If we turn to page 14 in the upper right hand corner, it's possible to derive from option prices what the market's expectation of what equity returns is. It's not really a crystal ball, it's not somebody's forecast, but if you look at the pricing of options on for example the S&P 500 you can effectively back out what the market's expectations are and if you look at that curve you can see there's a 3.1% chance that stocks will be up 30%, but that has a very marked negative skew that basically the positive outcomes are much less likely than negative outcomes. In fact the likelihood of the stocks being up 30% is less than the likelihood of stocks being down more than 50%. So this is a worrisome sign because these are people betting with their real money, this is not a bunch of talking heads talking on CNBC or CNN saying, we think the market will be good or we think the market will be bad. People have basically bought options that if you back out the implied expected return have a very negative view of returns in 2012. Now there's obviously these extreme cases of down 50% or down 40%, but there's a pretty fat part of the curve that's between zero and minus 20, more than 25% of probability that the returns for equity markets will be between zero and minus 20.

Another measure of risk is in the lower left hand corner. A put option is a security that you can buy or sell that gives you the right to make somebody buy something at a price and if you want to have what's called portfolio insurance or use a risk reduction technique, for example if you thought the market was going to go down and you bought an S&P 500 put at today's price and the market went down 20%, your gain on that put would be 20%, market down 20, gain on the put 20, you're insulated, you have no market risk. So if you buy a put you can basically insulate yourself from a market decline, however people selling puts who are on the other side of that transaction are going to look at the market and say things look really bad, they're going to price the puts very expensively, it's just a form of insurance. The best example is where I live in California I spend a lot of money on earthquake insurance, I don't spend any money on hurricane insurance. In Florida they don't pay a dime for earthquake insurance, nobody even has it, but they pay a lot of money for hurricane insurance. So when the cost of insurance gets very high then you have a sense that the market believes that things are going to turn downwards. That lower left hand line is the

cost of an S&P 500 put that is going to insulate you against a loss of more than 20%. To buy in the money put is very expensive so usually what you do is you buy a put that is 20% on the market, you will the first 20% loss, but you want to be insured against losses greater than 20% and you can see that obviously at the peak of the negative in 2007 and 2008 the cost of insuring against a 20% loss got to be 10%; literally for that to be paid off stocks have to be down 30% because you ate the first 20 plus you're paying 10% to insurance against further losses so you needed to have the market go down more than 30% for that insurance to pay off. Now it hasn't risen to that level but it's popped back up again much higher than usual, so the market is sending signals that things are not happy.

Page 15 looking at fixed income, the yield curve which is what interest rates are for the very shortest period all the way out to 30 years has flattened. Typically in a negative economic environment you get what's called a negative yield curve where short term yields are higher than long term yields and that's almost always a signal that a recession is coming, but that doesn't work anymore because the Fed has nailed the short term end at zero. So what's happened is you've seen the long end decline. Now part of that is the Fed's operation twist where basically they were trying to drive down long rates to benefit the mortgage market, but the yield curve has flattened out. We expect that investment grade bonds and investment grade high quality corporates still have a fairly low risk way to pick up additional return. We think that the treasuries are grotesquely over valued; the balance of risk of owning treasuries is very negative. Rates historically have never fallen below zero although there have been recent occasions where the Swiss sold Swiss T bills for negative interest rate, you paid them to take your money and there have been other occasions, one in the U.S. which is largely technical but literally the fear of holding bad credits is so great that people will pay to invest in less risky securities.

Let's go to page 17. Domestic equities really ought to be doing well; corporate profits are at an all time high. If you look at corporate profits as a percent of GDP, corporate profits are a component of domestic product, it's really at an all time high. Companies have basically been reducing cost, avoided hiring new people, avoided making investments, balance sheets are extremely strong and that's part of the reason we think credit is a good place and again that's corporate bonds, is a good place to invest because companies have very high operating margins, they cut their cost dramatically, they have very strong balance sheets, a lot of them could pay off all of their debt if they wanted to. So realistically for the S&P 500 to only be up 2.1% indicates still a lot of weakness in the equity markets and it was extremely volatile. In April year to date it was up 9%, at the beginning of October year to date it was down 11%. So volatility has been enormous, stock prices bounced around a great deal. We do believe again quality stocks have got a lot of appeal. We're negative on small cap stocks, they underperformed in 2011 in part because they have not really participated as strongly in the surge and profit margins that larger companies have. Larger companies have the resources to be able to improve their supply chains, improve their productivity and smaller companies tend not to and we recommend under weighting small cap stocks.

Let's go to page 19 looking at non-U.S, again, rough year for developed international markets. The S&P up 2, the EAFE Index down 12 and emerging markets fell even more. Japanese stocks were actually amongst the worst performers, clearly the economy was impacted by the tsunami and nuclear issues they had. We think that for the patient investor with staying power stocks in Europe which have just been beaten down to ridiculous valuation levels really would represent a fairly decent long term investment. You could be looking at a big loss in a day or a week. These countries are not going to disappear, basically

you're looking at paper losses, France will still be there, Greece will still be there, unless you own a bank or are a bank over there, life will go on.

If we turn to page 21, looking at emerging markets, again part of the emerging market decline was not that necessarily the emerging market economies turned negative, although they aren't growing as fast as they were, but rather that they got ahead of themselves, their valuations got to be very high and it really moved to get the valuation down to more reasonable levels. The second bullet there is significant, we actually think emerging markets have an attractive valuation. The price earnings ration on trailing earnings for emerging markets is almost 11, that's a 33% discount from the U.S., if you think the U.S. is cheap in terms of price earnings ratio, emerging markets are 30% cheaper than that so the effect of the decline and we've seen this repeatedly that stuff goes up, stuff goes down, but the object is you don't want to pay too high a price for a stream of earnings.

To get to the Committee Chairman's question, on page 23, private equity had pretty strong returns, there's a lot of different private equity kinds of funds. In the upper left hand corner you can see that there's Venture capital, buyouts, distressed, mezzanine, secondary, funds of funds, but basically we think that private equity is an attractive market particularly the ability to buy companies now with distressed prices.

Real estate, the REIT Index (this is the global REIT Index) gained 7.3% in the month but still finished with a 5.4% decline for the year. The U.S. REIT market was up 8.3% for the year so U.S. REITS did much better than global REITS (page 25). U.S. REITS were actually up 15.2% in 4th quarter so REITS had a very good period.

With that let me just give you some notes that I have collected. If you've seen recently the movie "Money Ball" and that was written by Michael Lewis who has written a number of very interesting books and he has a new book called "Boomerang, Travels to The New 3rd World, now the new 3rd world is us and I'm going to give you a couple of figures from that. The reason I started with debt as the topic and just the pernicious effect of the debt, the period from 2002 to 2011 world wide debt went from $84 trillion dollars to $195 trillion dollars. Doris Flores-Brooks: In less than a decade? Terry Dennison: In less than a decade. Doris Flores-Brooks: More than doubled. Terry Dennison: More than doubled, yes. There's a good quote that I saw from a professor from Stanford (University) that I think we need to need to bear in mind as we watch all of the great and the good try to tell us everything is wonderful. The quote is, "it's frightening to think that you may not know something, but more frightening to think that by and large the world is run by people who have faith, they know exactly what is going on."

In terms of global overview what we think is going to happen, the developed countries with flexible exchange rates, meaning they're not locked into the year like the U.S. and the UK have the ability and the willingness to print money. Growth has improved from low to moderate and the markets have reacted positively. Developed countries who lack these policy options, Italy and Spain monetary and fiscal conditions are tightening. One of the things that's very scary is the decline in the money supply and money supply is not just currency but it's also bank deposits in countries like Italy, literally the money is just fleeing the country, they don't trust their banks and that has the effect of reinforcing a collapse in growth and market stay and get even more depressed. Emerging market creditor countries with flexible exchange rates like India and Brazil, growth is slowing and the markets are under performing and emerging market creditor countries with linked exchange rates,

remember China you heard all this noise in Congress that China has pegged the Yuan to the dollar to make it attractive to their exports.

Growth has slowed from high to moderate and markets have fallen. We think that the U.S. short term, the best forecast is 2.3% for 2012, but that's probably optimistic, you need about 2.5% growth to keep unemployment stable, so realistically we would then expect unemployment to rise. We talked about household spending limited by credit availability, long term we just don't see growth returning 3 or 4% GDP level. Again the story is growth and debt. There are a lot of statistics floating around about the amount of debt there is, the official Government debt is now approaching $15 trillion dollars and we hear people talk, well it's about the same as a lot of other developed countries, but that's not right. I use to live in the UK and the UK is about the same percentage of debt to GDP that we have but the difference is all the Government debt in the UK is Federal Government debt, the counties, the shires don't issue debt, the cities don't issue debt so when the UK talks about its debt, that's all the debt there is. In the U.S. we talk about the Federal debt, well we have state level debt, county level debt, city level debt, school district level debt, every place you look there's piles of debt. The on balance sheet debt in the U.S. from all Governments is probably about $50 trillion dollars, about 3 times the U.S. Government debt. Doris Flores-Brooks: You're saying that the Federal Government is at 15 and everybody else, states are triple? Terry Dennison: States, pension funds, counties, remember the states have pension funds that are all under water, the total Government debt is about $50 trillion dollars, now put that in perspective. Doris Flores-Brooks: Can I just stop you right there. When we had last year and I was at the GFOA conference and the GFOA went out of their way to dispel that notion that pensions were under water and now you don't hear that, they went out of their way and now you don't hear anymore talk. Terry Dennison: Nobody wants to talk about it because if you talk about it then people realize how bad this is. There is definitely, not a formal but effectively a conspiracy of silence. Of course we can pay our debts, we don't know how we're going to do it but of course we can. Doris Flores-Brooks: That's scary, 50 trillion. Terry Dennison: Just to put that in perspective, that's more money than there is in the world. That's an interesting thought that we owe more, the U.S. Government and its subsidiaries, its other pieces owes more money than there is in the world.

If we look at private on balance sheet debt, this is what the households own, we're looking probably at something like another $50 trillion dollars, that's 350% of GDP, these numbers start to get ridiculous. The trustees of Social Security and Medicare said that the present value of unfunded liabilities was $60 trillion dollars and that's on top of the 50. Doris Flores-Brooks: That's just Social Security and Medicare? Terry Dennison: Social Security and Medicare is another $60 trillion dollars. Remember that picture of the trillion dollars?

Total Federal liabilities, not just bonds, but things like Government pensions, remember the Federal Government employees are not in Social Security, they have their own pension system, military pensions, military healthcare, the total of all this stuff is about $200 trillion dollars. Now we talk about growth, all the politicians, not just democratic, republican, we talk about let's have growth, you hear the Europeans, let's stop this austerity, let's pour money into the system and have growth, okay suppose we have this $200 trillion dollars and we're going to have growth and pay it off and remember this $200 trillion dollars is due in no more than 50 years, the longest U.S. debt is 30 year bonds, even Social Security that money for even a 20 year old is going to be due in 50 years, so that $200 trillion dollars is going to be due and payable and expected to be paid in the next 50 years. Let's talk about growth, 3% GDP growth a number we won't hit this year, about trend GDP growth with $15 trillion

dollars of GDP, 3% growth is about a half a trillion dollars year. So if we take all of the GDP growth and use it to pay debts, we'll pay off the debts in 400 years. Now the debts are due in less than 50 years, it's going to take us 400 years to pay them off, 400 years ago the Pilgrims landed on Plymouth Rock to give you a sense. So it's just going to be very, very difficult and let's talk a little bit about the effect of this on the economy because that's what we care about. This is a little simplified example and a lot of people are saying that part of our problem is we're use to economic cycles, we've had economic cycles for years, stock market does good, stock market does bad. I remember when I was growing up in the 1950's that the way you can tell a recession was coming was the number of car sales around the car lots, once the car dealers had more than 100 days inventory, they started to stop production and you can tell the economy went into recession because that was an industrial economy not just a paper economy. What we're dealing with now is not a business cycle, we're talking about a de-leveraging cycle, the level of debt we have is unsustainable. If we're going to start to pay it off, let me give you a little numerical example and this is a simplified example just to illustrate the point, but the numbers are relevant and I'm going to use it for household but it works for Governments too. Suppose you make $100,000 dollars a year and I'm going to ignore inflation, salary increases, taxes because in the reality the kind of net us, so suppose you make $100,000 a year, you have no debt and you're living a good life and then a banker comes in (I'm not after the banks), but somebody comes and says, you're a great credit risk, I'll loan you $10,000 dollars because you're such a great credit risk, so now all of a sudden you're living on $110,000 dollars and you're life just got much better and you're still a great credit risk and this goes on for 30 years. So now you owe $300,000 dollars and all of a sudden who ever is lending you the money says you're not a good credit risk anymore, not only will I not lend you anymore, you have to pay back what you borrowed. So if you pay back $10,000 a year you're going to cut your disposable income by 18% for 30 years, that's what de-leveraging is about. Now if you are particularly aggressive and pay back $20,000 a year, you're going to cut your disposable income 27% for 15 years. So this is not one of these business cycles where if you go on an extended vacation it will all be okay. A de-leveraging cycle is long and painful and given most people have fixed expenses like mortgages and car loans, if you cut their disposable income by 18%; you're cutting their discretionary income 80%. So that's why the stores are empty and the stores are dying and retail sales are low and the debt is going to come back and eat you.

Joe T. San Agustin: How come the manufacturing industry ---? Terry Dennison: To some degree commodity manufacturing moved to cheaper markets? Joe T. San Agustin: They're moving back. Terry Dennison: They're beginning to move back, it's called re-shoring. Basically a lot of people said, let's have out stuff made in China so that's off-shoring and now what we're seeing is re-shoring partly because China is no longer cheap, wage inflation is very high, turnover is very high, which means training costs and productivity are high and low respectively. Vietnam is now the cheap place to go, before long it will be North Korea as the cheap place to go and then I don't know where we go. The reality is transportation costs, quality, I mean how many horror stories about evil products in China, I certainly wouldn't eat or drink anything over there. Joe T. San Agustin: The milk. Terry Dennison: They've had multiple scandals of evil stuff in milk. So you're seeing a lot of manufacturing, particularly high value added manufacturing. If you're just pounding pieces of metal into ash trays, that's never coming back, but if you're doing high end manufacturing where there is skill involved, you're using computer controlled machines tools, it's small high value products sometimes actually coming back. So it's not all been one way, but I mean basically manufacturing has been hollowed out, we use to not necessarily be the workshop of the world but after post World War II we made pretty much everything we used, televisions came

from Zenith in Chicago, lawn mowers came from Briggs and Stratton in Milwaukee, now none of these companies are even in business anymore because it's just cheaper to get it in China and we've been reduced to making pieces of paper and as we discovered in 2007 and 2008, that doesn't work very well.

Another note from our friend Mr. Lewis, the Greek railways get revenues of about 100 million Euros a year, 100 million Euros of revenue from tickets. Their payroll is 400 million Euros a year and their other costs are 300 million Euros a year. The Greek railroads lose $7 dollars for every dollar of revenue they make. Gerard Cruz: That business model clearly doesn't work, so going back to your hypothetical adding on debt over the years, the idea that business has come into banks and they're good credit risks and we give them money, the point of us giving them money isn't to squander it on a bad business model, we hope that they're going to invest it in a plan that's going to create a profit and add to capital and create the jobs and grow prosperity. So at some point they begin to pay down their debt. My take really in this whole thing is that when we start talking those extraordinary numbers, trillions and they're huge numbers, we get to the point where as decision makers as complex as it is kind of raise their hands and say, this is just too big and they're just stunned and say, well there's nothing we can do and just throw their hands and go away. I don't know that the U.S. or any Government ever wants to be zero debt because then at some point there's going to be austerity beyond anybody's, we just won't be able to live. So there is a balance between zero and outrageous, I think we just have to find that balance, we are teetering on the outrageous, I believe it, but I don't think paying $50 - $200 trillion dollars to zero is reasonable and I don't think it's even prudent to take us down to zero, we have to find a balance and if you do grow the economy and pay down some debt, then I think we can find that balance. We have among other things, been paying for things that we should have never gotten in to and we are starting to scale back, the U.S. is on some expenditures. Doris Flores-Brooks: Where? Gerard Cruz: On military, we were spending about a billion a month just to run a war in both Iraq and Afghanistan and we can argue whether we stayed there too long or not but the reality is that there is some savings that are going to come from that and businesses are producing again and notwithstanding the production on the manufacturing being housed outside of the U.S., corporate profits at some point if we restructure the tax structure are going to come back to the U.S. so the money flows back in. We can stop things like transfer pricing and stop things like shields on the multi-nationals that keep profits off-shore and so those things can happen, it's complex but it's just difficult to hear on the Republican side (which I'm a member of that party as well) to just throw obstruction and large numbers so that the decision makers are almost paralyzed at trying to do anything because the problem is so big and that's been the posture not just with the Republicans but particular with the Tea Party and they've had 2 years to be in there, to try to get something done, I haven't heard anything from that and so that's kind of my take on this.

Terry Dennison: Well, I think with respect to what chance we have to fix this, it's obvious we just can't say, this is out of bounds or that's out of bounds, we have to do everything. Now the question is, is everything enough to fix things? You dig a big enough hole, Americans have kind of a built in feeling that we can do anything, we conquered the Frontier, we put a man on the moon, sure we can fix this, but you look at these numbers and you can say, well the debts are, who cares about the debts. My liability is somebody else's asset, if I stop paying my mortgage Bank of America is out their money, pretty soon my checking account will disappear. Gerard Cruz: But in our case China is our banker or some large country owns our debt, among everybody else, but it's in China's interest that we don't default also so there is a mutual interest that we prosper, there is a mutual interest in the part of our lender

that we prosper as well, we as a U.S. I don't think we're in this alone and I agree, I don't dispute the fact that the numbers are huge, I just don't know if we were back in 2007 whatever mistakes were made in the late 90's to create the bubble in housing I don't know if anybody would have done anything different and let's face it, TARP and all the bailout was a product of the Republican administration. So would anyone have done anything differently in 2008 which pretty much resulted in where we are today in terms of debt.

Terry Dennison: If you remember back in the last couple of years of the Clinton administration we were running significant surpluses. Gerard Cruz: By rises in productivity. Terry Dennison: Yes and people were saying, would it be good to pay off all the debt, now they were only talking about the on balance sheet Federal debt. Gerard Cruz: But even to that extent (And I don't mean to interrupt you), there is a lot of county, local and state debt, but unlike the UK, every one of those county, states and local have taxing ability that the UK, I don't know if their counties and states have the ability. Terry Dennison: There is no need to tax because there is no way for them to need money; it all comes from Federal Government. Gerard Cruz: So local Governments can tax, states can tax and if the state goes belly up maybe the U.S. Government will come bail them out, maybe won't. California has been teetering with, except for some funky accounting, were running huge deficits and IOU's and they moved their debts to the next fiscal year so that everybody could get paid. While those arguments are theoretically true in terms of debt size what also doesn't get talked about is the ability for states to tax which you're right... Terry Dennison: But at some point you run the limit of taxes. Gerard Cruz: Absolutely, I agree, but California is still the 8th largest economy in the world and they were teetering with (Arnold) Schwarzenegger on the brink of bankruptcy at some point of paying... Terry Dennison: Well they've always had and part of it is a dysfunctional Legislature and dysfunctional legislative rules. Actually California has been doing better, their budget deficit which was like $40 billion dollars... Gerard Cruz: With Jerry Brown? Terry Dennison: No, this was with (Arnold) Schwarzenegger. It's down now to about $15 billion because revenues have picked up, expenses have been cut. It's still in horrible shape but it doesn't look as bad as it was, it's showing some improvement. The U.S. is still in a much better place than other people and realistically the concerns that we have here are largely a little ways down the road, they're not 2012 issues, but in the next decade this enormous overhang of debt and it's the household debt, it's the state and local Government debt, it's the under funded pension debt and as I was saying before, the problem with this is everybody's debt is somebody else's asset and if we start to have large scale defaults, you're going to start to see asset holders, banks, insurance companies, pension funds who are counting on the value of these investments to fault on their promises so in a sense the simplest answer is, we as a society have made promises that demonstrably are almost impossible or cannot be kept.

George Soros was quoted saying this morning in the paper, basically suggesting that you're going to have riots and marshal law in the U.S. Joe T. San Agustin: Occupy Wall Street. Those people are getting bigger and bigger. Gerard Cruz: I agree there are a lot more people who are now involved with or have a greater understanding of the level of debt, but the question is, what do you do, so these guys occupy Wall Street, but what are you going to do? Do they really want the pay, do they know what austerity is, because they've lived a life of entitlements? Terry Dennison: Remember that graffito from Banksy, you know, what did it say, "the lifestyle you ordered is no longer in stock." Gerard Cruz: It's one thing to volunteer to live in a park, but it's another thing to have no choice but to live in a park. Terry Dennison: My parents and I'm sure pretty much everyone in this room were children of the depression and my family did okay, my mother's family were farmers and I didn't really

notice much, my father, my grandfather was an engineer and that was a different world, I mean people would stand in orderly lines, blocks long for a bowl of soup. Does anybody really think Americans are going to do that now? We're in a completely different world, I mean the world of the depression, the world of the greatest generation is gone. That's why I made the comment, seeing what's going on in Greece will probably go on in Italy, maybe have a salutary effect.

Doris Flores-Brooks: My question to you is, when is the Euro going to de-funk, go out of business? Terry Dennison: It could be as early as 3 weeks from now. Doris Flores-Brooks: That the Euro will no longer be, the EU goes away, that's what I'm hearing. Joe T. San Agustin: But Germany is ready to jump in and save them, Germany is still there. Terry Dennison: I think what you're going to see, there's too much advantage to having common currencies, you just can't have places the size of Rhode Island having their own money, that doesn't make sense. What you're going to end up with is a soft Euro and a hard Euro, the hard Euro is probably going to be called the thaler which is actually the root of the word dollar, thaler came from a town in Bohemia called Joachimsthal, it was a coin that was minted in the middle ages because they found silver in Joachimsthal. The thaler was actually the coin of Europe until the 1850's, it was the legal currency in Germany until about 1850 and it basically shared the European coinage with Spanish piece of eight and that would probably be Germany, Austria, the Netherlands, the hard currency countries. In fact I've heard statements that the best thing to happen to the Euro is not for the Greeks to leave but for the Germans to leave. But realistically I can't see everyone going back to the lira and the peso and the drachma. The politicians are all saying it will crash the Euro or it will crash the European Union, we'll go back to World War I. To some degree politicians like to make it scary for something to happen in the belief it will make it hard for it to happen, but every bank, every country is planning for the break up of the Euro. So I think it will be a big deal especially if you're in the affected countries, but people are doing sensible things, businesses, banks, insurance companies, Governments have contingency plans, they have this figured out, they know what they're going to do.

This is much less scary than Lehman, now it's much bigger in dollar terms, but Lehman literally started on Friday night, they said we will be in court Monday if you don't do something and there are books about the Lehman weekend and I've said before that I think it's going to go down in history as being as significant as the Cuban Missile Crisis, we don't know how close we got to the end of the world. People did stuff that was of marginal legality to save the world and they had no authority to guarantee deposits in money market funds, they did that because without that you would have total chaos, they just said the rules are inoperative if we have to save the world. Gerard Cruz: There were no case studies to report back to, there was nothing. Joe T. San Agustin: They had no choice. This one is not going to be a surprise, everybody knows, everyone is getting ready, everybody knows what's going to happen, the firewalls are there, the in case of emergency... and the reality is no amount of austerity will fix these problems. The Greeks had a very ambitious sounding program to sell public assets and to cut Government staff, not a single Government employee in Greece has been fired. The unemployment rate amongst people below age of 25 in Spain is nearing 50%, I mean, literally people have no food in Greece, you can't buy anything. There was an article in The Economist I was reading on the plane, they're now having strikes by truck drivers in Italy where the truck drivers just block the roads. Doris Flores-Brooks: Why? Terry Dennison: Because they're raising taxes on diesel fuel and literally they have cut the country in half, they blocked the roads all the way across the country and they had a picture. You can go on to, there is an Italian newspaper that has a website in English and they had a

picture of this toll station on one of the autostrada and the trucks completely blocked the road and they've been blocking it for days. The gas stations are going to go on strike for 10 days. The austerity has barely bitten there and so realistically you can't fix this by austerity, you can't fix this by raising taxes. Doris Flores-Brooks: Well how do you fix it? Terry Dennison: You just leave. Doris Flores-Brooks: Leave Guam. Terry Dennison: Guam has very much the same problem that Greece does. Realistically and I'm suggesting that it would be financially viable, you can basically devalue your currency and make yourself competitive. The problem is these countries can't. Doris Flores-Brooks: We don't sell anything, we're a service industry. Gerard Cruz: Neither does Greece. We don't produce anything. When you say leave? I'm talking about Greece leaving the Euro and going back to the drachma. If you go back to the drachma and devalue the drachma relative to the Euro by 30 or 35% they would be fine. Now everybody who had Euro liabilities like the banks would be instantly insolvent and you would have to deal with that. The problem with this debt is that even with our own TARP and all these other programs, the debt didn't go away they just sort of moved it around, let's hide it here and if it gets spotted there, let's hide it here. If you look at the Fed balance sheet, where is the debt now, it's on the Fed balance sheet. Wilfred Leon Guerrero: If we have the money pay it if we don't, I think that's the philosophy, that's what's happening here, if we have the money pay it, if we don't pay it. So that's how we see the world. Doris Flores-Brooks: What you're really telling us is, no growth... Gerard Cruz: We have to change our strategic allocation. Doris Flores-Brooks: Yes. To go into other areas. (End of discussion on economic & capital market environment)

DC Plan Performance

Terry Dennison: Okay, you have 2 books in front of you regarding a pension fund. I'm going to work out of the colorful one, but I'm going to have you go to at the appropriate time one page in the white one. If we go to (tab 2) page 17, the first tab is the market environment report and I gave you the long market environment report, this report is through 12/3. We'll send you another version of it that simply has more analysis in order to meet this meeting today because we had to ship this report last Thursday. The main development was the Nuveen-Winslow Large Cap Growth Fund was added to both the 401(a) and 457(b) plans as a result of the search that we did in 2011, this replaced the American Funds AMCAP Fund which if you remember we had concerns about the asset size and the fact it was really unlikely to out perform.

A couple of manager updates, just a little reminder of how the DC world or the mutual fund world works. Often you have a fund with a name like Hartford, you have one the Hartford total return bond fund, Hartford doesn't really manage that fund they outsource the sub-advice for that to Wellington Management which is a very highly regarded money management firm. The reason you do that and this is sort of behind the curtain of economics of the money management business, Hartford has because it's an insurance company has all these insurance agents who re-branded themselves as financial planners, so they have what's called in the business as "distribution," they touch a lot of people and can sell a lot of product and they want to be able to product that's branded Hartford or Prudential or whatever, but they're not really in a position to make the product so they outsource the actual investments, in this case to Wellington and previously they used Wellington and other sub-advisors, they're now going to concentrate completely using Wellington which is a very large organization which we have a lot of confidence in. All the fixed income mutual funds are going to get transferred to Wellington, we don't think it's going to make any difference at all, we're totally comfortable with it.

The second sub-bullet under Winslow, you've obviously just invested in the Nuveen Winslow Large Cap Growth Fund, this has no effect on you, in fact it's actually beneficial. There is a pejorative term in the investment business and the pejorative term is "asset gather" and this is really what we could have called American Funds, that they are just money grubbers, they take every dollar that they can get and at some point these funds become so large they can't add value, they basically look like the market and they're just ultra expensive index funds. Responsible money managers, the non-asset gathers, the ones who are putting their clients first instead of their own pocket books first basically closed the funds and said we won't take anymore money because we don't think we can find good investment ideas to invest in and that's basically what New York Life Investments which again is sub-advised with Winslow, they have closed this fund. Now the mutual fund is still open, this has no effect on your participants, but basically what it does is much raise the likelihood that you're participants are going to get continued value from the fund. They did the exact opposite of what American Funds did which was more money for us, more money for us, to hell with the customers. Neither one of those we think has a big issue.

If we turn to page 18 looking at the asset allocation for the combined plans and again the 401(a) and the 457 have very different allocations underneath that because the 401(a) was mapped over to the age appropriate life cycle fund, so you have compared to other funds we look at, an extraordinarily high allocation to the target date funds which we think is very good for the participants because the average participant really doesn't make good investment decisions. Even on a combined basis you still have two thirds of the money in the life cycle funds which we think is the best place for the average investor.

If we look at the asset allocation on a combined basis in numerical form on page 19, this doesn't change very much. If you look at the last column and again this is through 12/31, if you look at the last column things don't change much. We did see movement out of the target date funds, about 2.2% and again this is the combined, when we get to the 401(a) it's a little larger than that, going mostly into the Stable Value Fund. As markets get volatile and people who use the internet or the newspaper or some voice response system look at the volatility of these prices, a lot of people say, I can't take this, I can't sleep at night. Doris Flores-Brooks: I was surprised that people reallocated to the Stable Value Fund, it's not making anything. Terry Dennison: It's not losing anything either. Volatility is something that effects people that are at a very --- level because you get people who are thrill seekers, who get paid in the long term for taking risks, that's how the whole system works, if you didn't get paid for taking risks nobody would take risks, it would be just illogical. There are people who their utility function is such that a dollar gained is worth more than a dollar lost, the negative value of a dollar lost. Most people are what are called risk adverse; they would rather have a dollar than make a dollar. A lot of people looked at the volatility you saw in that chart, looked at it in the economic, the volatility is going up again looked in the newspaper, even reading the PDN what's going on with Europe, you'd have to live in a cave not to know that things are very difficult, the U.S. economy is still struggling, Europe, so I think it's not uncommon to see people flee to stable value. You are getting more of a return in stable value than you would say in a money market fund. Actually it's quite an attractive return because while it's not guaranteed and will fluctuate as Alice (Taijeron) can explain, the reality is it's a pretty stable decent return and it's very attractive. Partly because of the mapping exercise you're fund has only 8.3%. I have another client that has, because it's a corporate that has bought a lot of companies, about a $3 billion dollar DC plan and 40% of the assets are in stable value. People have basically just checked out of the game, they made

a lot of money, they lost a lot of money, they made a lot of money, they lost a lot of money. We think that's a suboptimal solution, I mean if you look at inflation, the Stable Value Fund offers a better return than zero but it's about a zero real return. If you invest in stable fund for 40 years, at the end of that 40 years you'll have a purchasing power of about as much money as you put in, you would have gotten on paper 2 or 3 or 4% growth, but in real return net of inflation, real return is what matters, net of inflation you'll have what you put in.

Wilfred Leon Guerrero: Alice (Taijeron), on page 18, what Terry (Dennison) is reporting, this is the overall portfolio, how does that compare with individual accounts, does this represent the asset allocation? Alice Taijeron: Yes, this is very close to if not exactly like. Doris Flores-Brooks: Does this include the 457 also? Terry Dennison: Yes, it's combined. If you go to page 20 and 21 you have the 401(a) and page 22 and 23 you have the 457(b). You can see in the 401(a) it's almost 70% more than two thirds in the Stable Value Fund, where in the 457(b) on page 22 which wasn't mapped, still has a surprisingly large allocation and it's not two thirds, it's only one third. Now remember the 457(b) being optional, probably has and all of this is generality and probably insult somebody here, a somewhat more sophisticated participant, they tend to have more money because they have enough extra money that they can make an additional contribution. Wilfred Leon Guerrero: It seems like they're favoring Lifecycle (Funds). Doris Flores-Brooks: Because they might have more money but I think they have more time or interest or ability. Terry Dennison: Or more knowledge. If you look at page 23 you can see a lot different behavior, actually a tiny amount was withdrawn from the Stable Value Fund and money went in to Large Cap U.S. Equity, Small and Mid Cap U.S. Equity and Small Cap U.S. Equity. So amongst the sort of notionally more sophisticated investors, the money was flowing out of the safe investments, out of the Lifecycle Funds, out of the Stable Value Fund and in to risk assets. You can see kind of an interesting dichotomy between the 401(a) participants who basically favored security, you have this more aggressive and of course this is supplemental plan (457b) so presumably people had other assets and they're using this more as an asset investment pool than a core investment option.

If we turn to page 26 looking at investment expenses because we want to see the minutes to demonstrate our fiduciary, in general you're getting pretty good deals, the only are as always, Baron, Champlain and Thornburg which are also pretty good performers and remember the performance is all net of fees, so while the fees are high the returns even net of fees are high. The remaining asset classes are well within traditional levels, this startling number is the emerging markets. Now the DFA process is much less expensive to execute so they can do it real cheap, but basically the median emerging market fund was paying 125 basis points, your participants are paying 65 so they're getting a real bargain and performance very close to what other people are getting so that was a very good choice on your behalf.

On page 25 and for the life of me I don't know why these figures are so funny, they're suppose to be red X's and green checks and these were draw by a computer and it's like the computer just had an off day or the printer had an off day, but the red is in the right place and the green is in the right place, it's just the figures are distorted. The reality is we continue to see by small market margins and we look at the numbers you'll see truly are small margins, the BlackRock funds are under performing by a little bit. Doris Flores-Brooks: What happened there? Terry Dennison: Because they're passive, the implementation of them is passive... Doris Flores-Brooks: That's where all of the portfolios are. Terry Dennison: Right. Now when we get to the real numbers you'll see these are not grotesquely bad. The interesting thing is with the BlackRock relative to the index it's really an index they created, so they're under performing a little bit but they at least have the

intellectual integrity not to move the gold post. I have a number of clients with Fidelity and they had a similar problem, they just picked up the gold post and moved them so all of a sudden they're doing fine again against their index.
If you go down to the Windsor II Fund and below, the active funds you have an excellent set of green checks. Again the participants should be very pleased with the funds that you've offered them, they're amongst the best performing funds out there and some of them have racked up very good long term performance records.

I'm going to go to page 27 instead of page 26 because it has more numbers. Here what we're looking at, individual funds and again this is 12/31, looking at their index and what potentially a secondary index is, then if there's a universe that's relevant, what the universe median is and the fund rank in the universe. Again the symbology is shown at the bottom, in terms of under performing the benchmark or over performing the benchmark, a conventional red and green and for the universe green is above median, blue is 3rd quartile and red is down in the bottom 25%. Galliard whose target is the T-Bill rate plus 100 basis points on an annual basis so it --- at zero that means the benchmark is really 100 basis points. you can see for one year it returned 1.9% versus an index of 1.1%, so the participants moved their money to the Stable Value Fund for the year it got 1.9%, again kind of inflation, core inflation was 2.2% so they lost a little in terms of real return but they didn't see the kind of volatility we saw, remember in April it was up, in October it was way down then it ended up about flat.

Turning to the U.S. fixed, the Hartford Fund solid 2nd quartile performance above the median all but for 5 years and generally around the benchmark. Obviously the Barclays Aggregate has been interesting because the 25% of it that's treasuries has done extraordinarily well as yields have fallen almost to zero. In order to match that index you had to have nearly index weight in treasuries, well if treasuries were over valued to hold index weight really was a high risk strategy, it seems odd to say holding U.S. treasuries is a high risk strategy, but if they're so over valued because rates have been driven down to ridiculous levels, unless you were willing to take the high risk of holding that much U.S. Government, you under performed and they didn't do badly, for the year they were up 6.6%. The benchmark which benefited from 25% treasuries which nearly nobody holds, was up 7.9% but the typical manager, the median manager was up only 5.6%, so they were in the top 3rd, so I think the Hartford is doing fine.

The star of the show as we saw in the market environment is the treasury inflation protected securities. Now you could say, how in the world could inflation protected securities be up 11.8% in a year where inflation was 2.2%, core inflation 2.2%, headline inflation about 3.5%. Well the answer is, as rates fell the impact of falling real returns hugely benefited treasury inflation protected securities. So, you had a bond guaranteed by the U.S. Government protecting you against inflation that went up almost 12% in a year and it's not a lot of money because I don't think people are fearful of inflation. It hasn't pulled in much on a combined basis, it's only a little short of $1 million dollars, only one third of 1%, but for the people who did invest in that, it was by far your best performing asset class. If you look at it even for 5 years, that 8.1% return compounded for 5 years, it wouldn't have doubled your money but it probably would have increased your money 70% in a 5 year period when the stock market was down. I'm not suggesting by any means, I'd hate to see everyone move their balances, I'm not saying by any means it's likely to continue but you did have kind of a paradoxical situation where the Government securities, treasury guaranteed securities insulated against inflation was the best performing asset class in the portfolio.

The International Fixed, performance volatile for 6 months, this is the Dreyfus/Standish International Fixed Income Fund, for 6 months which would be the last half of 2011, up 1.9% where the median manager was down 2.1%, that put them in the 13the percentile, nearly the top 10%. Now obviously international fixed, the managers are not going to own a lot of Greek debt, that's part of what you pay active managers for, but if you think about it, most debt outside of the U.S. except for German bunds and Swiss bonds, probably was taking it on the chin. Realistically obviously all of Southern European debt was doing very poorly and even the French bonds were starting to see their spread versus the German bonds rise, so these returns are not bad, 1.9% for the year for investing internationally, you paid a bit there to be diversified. No issue with the fund. Doris Flores-Brooks: Even though the return is 1.9%, it's red because it's not... Terry Dennison: It's below the index. So like in the BlackRock, it did return 6.7% but it's still red because it's below, but the overall return is still okay? Terry Dennison: Yes.

If we turn to page 28 now we're into the 2 families of Lifecycle Funds. First there is actually a balanced fund, that's part of the SecureFoundation and then we'll look at the 2 specific target date funds, all of these have been categorized as sort of in the Lifecycle category. The balanced fund is a combination of bonds and stocks so it's a blend, it's not really suitable for anybody's particular asset allocation and the blend is moves very little in a band so it's not like a target date fund that becomes more conservative as you age. It's not trying really to time the market, if they think the equity markets are cheap and therefore attractive they will increase the allocation modestly and conversely they'll decrease it modestly if they think it's over valued. Performance has been good, above the median or near the median across the board, above the or matching the index or the universe median, good fund.

The target date funds have staged a bit of a rebound, again the implementation here is passive and passive and active management kind of trade off depending on the market psychology. Clearly the 4th quarter which was a good quarter, the funds did very well, literally the Retirement portfolio was in the top 10%, 48% return versus 4.2% for the custom index and 3.6% for the typical fund of a similar category, it's also been a strong performer across time. The 2020, 2030, 2040 and 2050 all were above their targets and with the exception of the 2030 were above or at the median, longer term a lot of relative volatility. Most target date funds are active partly because active funds can charge higher fees or have higher fees so the people providing the funds who like to make money have chosen to make the funds active. The Committee chose to have passive based funds because they were cheaper for the participants and over time have not really suffered a performance difference relative to the benchmark.

If we turn to page 29, we can look at the SecureFoundation funds. These don't have much history but the history they have is very good. The performance is very close to median, you see numbers generally between 40 and 60 on a percentile basis. The 2015 fund is consistently above the median and either close to or ahead of the benchmark. The longer funds struggled a bit for the first 9 months of the year but basically came back pretty well. Because this family is on the half decades and the BlackRock is on the even decades I was going to see if it would be possible to compare the 2 funds and you really can't, you can't look at the 2020 and say, the 2020 on BlackRock and see how well it's done because clearly the secure horizons have an additional feature of providing this income for life factor, but you really can't do that because these funds because they were placed in the fund when half decade was the right place to be are on the 5's the others are on the 10's, they aren't directly

comparable, but it doesn't look just looking at say, the 2035 and comparing it with the 2040 and the 2030, it doesn't look like people are paying a huge penalty to get this additional feature.

Going to page 30, the index fund continues to match the index perfectly. One advantage is the Vanguard is so large they're fully replicating the index. One thing that's gratifying, if you go to the Vanguard Windsor II, those of you have better memories or have done your homework, you can remember when we were getting edgy about the Windsor II Fund, it had a period of significant under performance. This is a multi-manager fund and I think it has 4 sub-advisors, 4 or 5 sub-advisors and the idea behind a multi-manager fund with multiple advisors is that you don't have a big problem is somebody gets it all wrong, but conversely it's unlikely that you will be super because that will require everybody to get it exactly right, but one of the things that has happened is they made some adjustments to the sub-advisors and their performance has improved dramatically, now it's 1st and 2nd quartile performance back 5 years and if you look at some of the returns relative to the Russell 1000 Index, outstanding, one year 2.7% versus an index of 0.4%, 14th percentile, 3 years 13.0% versus 11.5%, 22nd percentile, so this is a fund where the fact that the Committee stayed with them has paid benefits for the participants that basically this has turned into a very solid player. It slightly lagged the value index for the quarter but still was nearly in the top 3rd of other value funds. The thing about the value index that makes it very difficult sometimes to match is that's where all the financial stocks live. If you've lost over the last 5 years 80% of your value or 80% of the price, you're a value stock, so all it takes is a little bit of good news and the bank stocks rally and then it gets very hard to match the index unless you also have a big pot of bank stocks, so a lot of managers lost relative to the benchmark when the bank stocks rallied on a bit of good news because they wisely said, an asset that's lost 90% of it's value in the last 5 years is not something we're going to play with mutual fund money.

The Nuveen Large Cap Growth Fund basically had a more difficult quarter although difficult in a sense of only up 9.1% where the index was up 10.6%, 60th percentile, not bad but clearly lagging a bit, longer term of course the record is good.

We had a discussion internally, we had the Franklin Fund some time ago on watch because of issues with the management which we really resolved and I had a discussion with the people who helped me produce this report about whether or not we wanted because of not acute bad performance, but kind of ho hum performance whether or not we wanted to put them back on watch and collectively we decided it wasn't appropriate at this time but it's kind of on, it's not an official recommendation to watch. If you look at the big book where the recommendations live it says retain, but it's sort of, in the back of my mind we'd like to see their performance improve. Again the performance isn't bad, in fact it's been around the median but it's lagged the benchmark, for one year down 4.9% versus 1.6%, but even that was only in the 61st percentile. One thing we need to be careful of is not react as we saw with the Vanguard Windsor II, if you just arbitrarily say, a couple of quarters of bad performance, off with your head, you end up getting rid of funds that basically they're style was out of favor, we've gone to the expense of doing a search, changing all the communications, going to a lot of work and likely moving from somebody who has recently been doing well or from somebody who has been recently been doing well to doing poorly because their style was out of favor to somebody who is doing well because their style is in favor just in time the styles change. We would recommend a continuing retain here but it's go a little asterisk in my head.

Barron Small Cap Fund, very volatile, we can see it's had a kind of tough 6 months, but one year, 3 years, 5 years very solid performance for the 0.7% of the money that's been sitting in it and when it's good it's great but if you look at it for 3 years, 18% return per year versus the benchmark of 15.6% and a median of 17.1%, about top 3rd.

The Champlain Small Company Fund, the small cap fund obviously just had one bad quarter and hopefully we'll see it go back to it's prior stellar state, for one year it was up almost 4% where the market was down more than 4%, so this one not only has added value in up markets which is the one year and 3 years, but also added value in down markets, for 6 months it was down 4.6% and remember small cap was a poor performing part of the market, it was down 4.6%, the index was down 9.8% and the median small cap fund was down 9.1%. Value added comes from both positive returns in good periods but also less negative returns in bad periods.

Page 31 looking at the Thornburg Fund, again good performance for the long term, a little bit more difficult, again this is a value fund, this is again where the bank stocks in this case non-U.S. bank stocks live and my guess is every time there is some kind of big summit in Europe to say, we now solved the problem at least for a the next couple of days, the bank stocks rally which makes it very difficult for people to match the benchmark unless they hold that same proportion of bank stocks.

The DFA again very good performance benefiting clearly by the fact they have very cheap fees, all these fees are net of fees. For the quarter they were actually positive, they were up 4.5% versus the emerging market benchmark of 4.4% and a universe median of 4.4%. They had negative numbers for one year because the emerging markets were a very poor asset class to be in during that time, but the losses while more than the benchmark are not significantly more, basically they lost 10% more than the benchmark, the numbers are big but so is the benchmark loss.

The one thing that I would point out and this is why I asked you to have the other book handy, in the condensed book which we were asked to use just because the meetings are more condensed, page 11 is intended to remind everybody where we are in terms of the funds we offer participants and this is not a call to action but rather a seed to be planted which at this point we're not even really prepared to make a hard recommendation or for that matter implement a recommendation. You pretty much have funds all the way along the continuum, there are no real overlaps, we don't have 2 funds in the same place, we give people who aren't investing in the Lifecycle Funds the option of just about every asset class, there are no overlaps, there's nothing confusing. There has been growing interest in what are called real return funds or potentially real asset funds. Going back to that subject on debt and I'll use Social Security as an example, there is always this question of, are we going to be able to pay Social Security and one thing I can absolutely positively guarantee on behalf of Uncle Sam is that you will get your Social Security check, what they can't guarantee is that you will be able to buy anything with it because at the end people stare at austerity, they stare at disorders or riots or social collapse and they print money, at the end they always print money. That is why I put in that image of $100 trillion dollar Zimbabwean note. While inflation now is insignificant, it's almost nothing, realistically on a going forward basis at some point inflation is going to become an issue and we've been investigating the desirability of recommending adding two 401k plans, a different kind, not to replace the TIPS Fund, but a fund that invests in what are called real assets and real assets are commodities, gold, oil, futures on corn, literally instead of pieces of paper, tangible assets.

Realistically and I made this joke that the Government couldn't guarantee you could buy anything, if you had a high inflation environment and you had a barrel of oil or a bushel of wheat, would you be willing to take a piece of paper for that barrel of oil or bushel of wheat? Probably not. The idea behind the real return fund or real assets fund is to provide an option for people who become concerned about inflation, with a fund that doesn't invest in bonds and stocks and paper assets but rather invests in real things, that's why they're called real asset funds, it's not a paper asset like a stock or a bond, they're investing in commodities, they might own timberland. The beauty of timber is timber is a unique investment, if paper prices are high you cut down the trees, if they're not high you just let the trees grow and what's called biological growth is about 14% a year, the trees just get bigger. Pension funds have invested for years in timberland and pension funds own enormous, if you go to the south island of New Zealand where there are lots of forests, most of those forests are owned by U.S. pension plans. Joe T. San Agustin: The Government of Guam Fund bought Orchard way back, acres and acres in California.

Terry Dennison: We're not ready to make a recommendation but just to give you something to think about and obviously at some point we will work with Great West because it has to be on their platform, it's early days yet. Doris Flores-Brooks: How would you collect it if you turned it in? Terry Dennison: How would you collect what? Doris Flores-Brooks: When you're ready to cash it in. Terry Dennison: No, you're invested in a fund, the manager... Doris Flores-Brooks: Do they pay you back in oil or do they pay you back in cash? Terry Dennison: They're all traded in cash. You always hear these stories about somebody who bought a futures contract and somebody dumps thousands of bushels of corn in their driveway, that kind of stuff really doesn't happen, nobody takes in-kind delivery, all of these are paid out in cash.

Wilfred Leon Guerrero: You don't have any recommendations? Terry Dennison: No, there are no recommendations right now. Wilfred Leon Guerrero: Let's take a look at page 27, I have a question on BlackRock 2040, it looks like it's been underperforming and you're still recommending that we stay with them. Terry Dennison: One of the issues with the Target Date funds is it's very difficult administratively to have a hybrid with multiple families, either you get rid of all the BlackRock funds and replace them with the Fidelity Freedom funds or the Schwab funds or the T. Rowe Price funds. Let's look at the 2040 Fund, let's go to page 30 and look at the performance, for the quarter it was 8.2% versus the benchmark of 7.5%, so for the quarter it beat the benchmark by 70 basis points, it was in the 56th percentile, roughly median. For 6 months it was 60 basis points behind the index but it was in the 29th percentile, for one year it was 20 basis points, so better than the benchmark. Wilfred Leon Guerrero: Why is that minus 2.4? Doris Flores-Brooks: It lost money, but it lost less money than the index. It lost money but not as bad as the index, the index was -2.6. Wilfred Leon Guerrero: But it's green. Terry Dennison: It lost less money. Doris Flores-Brooks: It out performed the benchmark, its loss was less. Terry Dennison: So basically the picture here is a mixture and again because these are passive it really depends a lot on whether or not the market behaves like the index or there is real value added by being active and our view frankly is it's hard for active managers to add value. To get to your specific question, it would be very difficult to replace this, in fact I'm not ever sure that Great West would do it. Alice Taijeron: To replace BlackRock? Actually I was just going to indicate that we are going to be adding zero date funds, 2020, 2030. Terry Dennison: Okay, but I was saying just to replace the 2040 and put in the Fidelity 2040, you would be replacing the whole family. Doris Flores-Brooks: When you say these are passive, what do you mean? Terry Dennison:

They are multi-asset class funds so they have bonds and stocks and cash and probably real estate and a few other things. Doris Flores-Brooks: So they're diversified. Terry Dennison: They're diversified, but each sub-component for example, the U.S. equities is not managed actively, it's basically constructed of index funds and in certain market environments it's easy for active managers to beat the benchmark, beat the index which makes the active funds look better and in certain market environments it's hard for active managers to beat the benchmark which makes the active look worse. At this point it's really hard to make a judgment but just looking I don't see a compelling reason to change out the whole set and that is what you would have to do, you would have to replace them and the reason we selected the passive is our belief and I think the numbers are demonstrated that in the long term you're better off paying low fees and getting passive returns than somebody trying to add value and collecting high fees. There are not a lot of places to go to find Lifecycle Funds that are passive because BlackRock is making less money with passive than they would be if they had them active because active fees are higher. Managers basically behave in their own self interest, they want to be active because of the pretty much misguided belief that they can add value but they know they're going to make more money, they can't guarantee they'll add more value, but they can guarantee they'll make more money.

Wilfred Leon Guerrero: Okay, thank you. Doris Flores-Brooks: As always, I appreciate your market perspective. (End of Tape 1)
(End of discussion on DC Plan Performance)

Respectfully submitted,

Stephanie A.H. Limtiaco
Recording Secretary

Affirmed:

Wilfred P. Leon Guerrero
Chairman