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 STABILITY • SECURITY • REWARDS

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**Defined Contribution Plan**  
**Quarter Ended December 31, 2012**  
**Quarterly Performance Meetings**  
 January 24, 2013  
 Retirement Fund Conference Room  
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 Wilfred P. Leon Guerrero, Ed.D, Chairman, Investment Committee  
 Gerard A. Cruz, Trustee  
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**Staff Present:**

Paula M. Blas, Director  
 Diana T. Bernardo, Controller

**Other Present:**

Terry Dennison, Mercer Investment Consulting Inc.  
 Doris Flores-Brooks, Office of Public Accountability

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

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## **Economic & Capital Market Environment**

Terry Dennison: I'm going to hop around little bit like I told you before in the former life I use to teach school and this is an old school teacher trick for making sure the class is paying attention. Start with the book with plastic cover, turn to page 1, talking about the Market it's been an interesting 4 quarters in 2012. We had a good 1<sup>st</sup> quarter, a bad 2<sup>nd</sup> quarter, a good 3<sup>rd</sup> quarter and a mediocre 4<sup>th</sup> quarter so you had this sort cyclical to it. If you look on the left hand side the market performance for the quarter basically other than the small cap area the performance on page 1, the performance is was not very strong not terrible, but not very good. But once you get in the small cap area it was fairly respectable with returns of 1½ or 2%. The thing that's interesting is how much stronger moving down to the next grouping the International returns were this is largely due to the decline in the value of the dollar is down about 2% on a trade weighted basis including against weak currency like the Euro the only place where there was substantial strength versus the yen which basically just nose dive during the quarter. Turning to the bonds side pretty much flat performance interest rates rose very slightly during the quarter basically enough to eat up the coupons you ended up with about a zero return. Then the last grouping is looking at some more specialty asset classes the REITs's had a good quarter and in fact look at the full year performance the REIT's had a spectacular year. Wilfred Leon Guerrero: Terry what is DJ UBS? Terry Dennison: The Dow Jones Union Bank of Switzerland Commodity Index. Commodities struggle clearly slow down and demand in China basically just slow down and demand everywhere made things like copper and gold all these including energy commodity of course decline substantially in price. The Dow Jones and S&P have two quite different constituents the Dow Jones has a very high energy allocation the S&P has a rather smaller energy allocation that's why the big difference in something is kind of measuring the same thing. If we turn to the 2<sup>nd</sup> page looking at the Macro environment we're going to return to this a couple of times because it's that important. We had a really good 3<sup>rd</sup> quarter in terms of GDP in the U.S. 3.1%. The census that it probably decline to about 1½% in the 4<sup>th</sup> quarter although there is some possibility that corporations anticipating the fiscal cliff and the likelihood of higher taxes maybe had increase activity in the 4<sup>th</sup> quarter although it really doesn't indicate a trend it really indicates borrowing from the 1<sup>st</sup> quarter. So if the 4<sup>th</sup> quarter was strong and certainly 1½% isn't the 1<sup>st</sup> quarter of next year is going to be much worse because some of the activity was move into the 4<sup>th</sup> quarter of 2012 in order to reduce taxes.

Unemployment is continuing to fall but will see when we look at another graph it has more to do with labor force participation than actual jobs being added more people are dropping out of the labor force now part of that is age we're now into certainly that fat part of the baby boomers but no longer in the thin wedge of the baby boomers a lot of people have gotten to mid-sixty simply withdrew from the labor force. The economy only added about 150 thousand jobs during the quarter it's generally believe you need about 200 of 225 thousand in a stable participation environment to cut unemployment. The unemployment rate fell dramatically but more having to do with people dropping out of the labor force rather than actual improvement. Wilfred Leon Guerrero: What's happening in Japan? Terry Dennison: Japan of course has been in a recession or depression for 20 years they elected a new government and Prime Minister Abe' basically more or less told the bank of Japan to significantly increase the liquidity. He basically is targeting a positive 2% inflation rate were

actually inflation but negative. Prices have been falling in Japan for years, Japan has some structural issues it is much more indebted actually then even Italy or Greece.

Now they owe most of the money to themselves they don't have a large external debt but they have a very high government level of debt. So, the Bank of Japan has not stimulated the economy probably or tried to for the last 7 or 8 years. The last time they tried, I was actually in Japan and their idea was to give everybody the aquiver \$200.00 gift certificate kind of gives you a sense just how they we're out of ideas. He now want them to target a 2% inflation rate which to do that basically you have to turn around the deflation and push it back up you see that in the currency if you turn to page 3, upper left hand corner Performance of Foreign Currencies versus the US Dollar. Wilfred Leon Guerrero: I don't understand that Terry he ordered the bank to set the target of inflation. Terry Dennison: Inflation basically he wants inflation because right now what they have deflation they have prices and the values are falling and deflation this was when we had the deflationary scare 2008 period the concern about inflation is this if you want the economy to grow you want people to buy things today and people buy things today one if they have money and two they think going to be more expensive in the future. If you have deflation the thing is going to cost you a hundred yen today is going to cost you 98 yen tomorrow you won't buy it you'll just wait. So the reality is so that and you're seeing the same pressure with the European Central Bank that they're now trying to produce inflation we tend to think of inflation being negative but the reality is trying to produce inflation because that forces people to buy today and increases economic activities now the danger is you can get runaway inflation kind of inflation you had in the 30's in Germany the reality is that most of these economy are in the deflationary spiral and you get into a deflationary spiral because you loose your job and you stop buying things and well the people you bought things from are no longer selling anything so those people loose their jobs and what you have is what you got in Greece, Italy, Portugal and Spain or unemployment 10, 15, and 20 youth unemployment Spain over 50%. And in reality is to get out of that deflationary spiral you need to get people to buy things today so while it seems unorthodox to want to encourage inflation the moderate amount of inflation the Federal Reserve inflation target is also 2%.

We're actually running above that, we're running about 2½% inflation but that's actually healthy if you had zero inflation there would be no economic incentive to buy anything today. If you have negative inflation deflation you absolutely won't buy anything today because you'll buy cheaper tomorrow. So there trying to stimulate the economy you'll see the effect of that again if you turn to page 4. Doris we are in the book with the plastic cover. And you look at the bottom the worse performing Foreign Currency versus the US dollar upper left hand corner of the bottom row. Japanese yen down 1.3% for the Quarter.

Basically you have this kind of trade off if you want to stimulate the economy by producing inflation that reduces the value of the currency. So that's why you had literally the currency just crash. Now the interesting thing about this is the Japanese economy is dominated by large multi-national, meaning they sale all over the world exporters what's bad for the currency is good for the companies because a portion of their cost are in these depreciated currency so when we take a look at what happen to the stocks, the stocks sorts the currency going down and the stocks go up because the currency going down is good for

sales of multi national corporation there now basically selling things at a permanent relative to their currency 10% sales. What cost them a 100 thousand yen to make now it has a cost equivalent of costing only 90 thousand yen to make in terms of what their getting back in dollars. And in fact there's kind of a low grade currency war going on everybody trying to reduce the value of the currency it's called competitive deflation of currency values because if you have the high currency value your exports go down if you think about of Germany 40% of Germany GDP is exports primarily machines to export in the world.

The strong Euro and the Euro is actually sorted value because they have among the highest interest rate any establish economy in the world. The US has cut its interest to zero, the Bank of Japan has cut interest rate to zero, the Bank of England pretty much at zero. So, all of their competitor's in terms of currency value are paying next to nothing or nothing on reserves. In fact, Switzerland actually has got a negative interest rate you pay them to take your money. So, the reality is that the Euro right now is strong not because the European economy is strong they're a total wreck. But, the currency is not as dependent on what's going in the real economy as it is in the differential between interest rates so that's why you saw the Japanese currency go down because the government has basically said we are going to print money as fast as we can print it and drive the inflation rate up to 2%. Well, money in the short term response to supply and demand.

The supply of money increases the demands stay constant the value goes down. So, that's why you see that sort of a nominal thing. Wilfred Leon Guerrero: just on the side here we are feeling this effect, already because I understand the numbers tourist come to Guam from Japan is down and this is usually our high. Doris Flores-Brooks: down or up? Wilfred Leon Guerrero: down. Doris Flores-Brooks: Because in looking at the Airport's number, well this is for fiscal year 2012 we got 1.5 million the highest ever. Wilfred Leon Guerrero: But, usually we get good numbers around this time of the year and it's not happening. Doris Flores-Brooks: Really? Wilfred Leon Guerrero: Yeah. Doris Flores-Brooks: Okay. Well, the Airport's audit will be released next week and it's the highest ever in 11 years. Wilfred Leon Guerrero: 2012 is a good year. Doris Flores-Brooks: But, 2013 is not. Wilfred Leon Guerrero: It's not turning out to be a good year. Doris Flores-Brooks: And that's because of what again. Gerard Cruz: The yen is about 89. Terry Dennison: It cost Japanese visitors 11% more to buy the dollars they spent here. Gerard Cruz: last year is around 78-76. Terry Dennison: The value of the yen has fallen about 12%. Doris Flores-Brooks: Because the yen is stronger. Terry Dennison: Yes, no the yen is weaker versus the dollar, the dollar is stronger. Gerard Cruz: So, it takes more yen to get to Guam. Doris Flores-Brooks: Okay, thank you. Terry Dennison: Remember they're buying dollars 11 percent more yen to buy a dollar. Gerard Cruz: Everything on Guam is 11%. Doris Flores-Brooks: But, if you didn't go last year you wouldn't know that now, right. Terry Dennison: Well, they're looking at what it cost to do it. The airfares are up, and if you look at the hotels. The hotel rates can stay the same in dollars but they went up 11% if you're spending yen. Doris Flores-Brooks: Okay, I got it now. Well this is the first month of the year. Wilfred Leon Guerrero: This is the busiest time of the year. Paula Blas: January is a good month usually. Doris Flores-Brooks: And it's not. Wilfred Leon Guerrero: No.

Terry Dennison: Clearly, your economy is very dependent on Japanese tourism and their ability to spend, literally, in the last couple of months has been reduced substantially.

Realistically that's not going to change, they're not doing it to hurt you, but they're trying to strengthen their own economy. Clearly, if they can turn around this 20 year decline. Gerard Cruz: Okay, what happens, because you're right there is a strategy by all countries to race to the bottom. So, everybody is trying to devalue their currency in order for their export to look more attractive international market. So, what's the end result. Terry Dennison: Well, at some point you start to get distortions that everybody cost structure is the same and also a lot of things now are made in multiple countries or made of components from multiple countries. If you buy American car probably 40% of it is made some place else so at some point it can't go on forever and the other thing it will eventually do is cause interest rates to go up. Who is the biggest debtor in the world the governments, everybody figure out that when US interest rate goes up the debt expense that the US federal government have to pay the interest is going to consume most of the discretionary federal budget so there playing a dangerous game they lit a fuse and they hope to be able to stop it from exploding the bomb. But the reality is that inflation or what you're going to get when the value of the currency goes down you are going to see price of goods become much higher by definition. If you have a bushel of wheat or a barrel of oil and the currency is losing its value you are going to want more for that. So, this is why commodities are seen as a hedge cassis kind of inflation. If you got oil or copper in the ground the reality is that the level of value independent of whatever the Government says the currency is worth this is the reason gold is gone so much. Gerard Cruz: Gold has kind of level down a little bit. Terry Dennison: Gold has trended down that is responding not just to inflation, but also fear of economic collapse. If the fear diminished gold slip back down but people with the gold say gold is the currency that you can't print, it's not subject to government manipulation. Do you know that all the gold that has ever been mined in the world is a cube 65 feet on the side. Doris Flores-Brooks: What? Terry Dennison: If you put all the gold that has ever been mined in history in one place, it's a cube 65 feet on the side, there isn't that much gold in the world. Now, the fact that it would probably sink into the earth. But, in reality is that's all the gold there is, ever since pre-history people are mining gold because it's pretty easy to smelt that melts at a little temperature. But, that's all the gold there is in the world 65 foot square cube.

Doris Flores-Brooks: Can I ask to shift back, the Congress has agreed to push back the debate on the debt limit and there was this comment by Bornanky that we don't really need a debt limit and all of this type of stuff and I was curious what your thoughts are on that and how important is that. Terry Dennison: We'll get to the debt limit. I got lots of notes, no plans for the rest of the day. Doris Flores-Brooks: Okay, because I do look forward to this and this is always a good education for me to know what's happening.

Terry Dennison: Let me take you to page 4 let's take a look at the bottom chart there, Sector Performance. Sector Performance tells you a little bit about the psychology in the market the top bar financials, is more of a, the world is not coming to an end rebound. Banks have been driven down obviously all the problems we talked about for years now they have a very good product this is just not banks this is all financial institutions. The thing that is interesting if you look at some of the better performers industrial, minerals and consumer discretionary those are the sorts of asset classes that do well in a secular rise. People are buying goods there buying industrial products that are made from materials consumer discretionary people now think they have money to spend instead of holding on to every

dollar the consumer discretionary these are things that consumers buy that you could live without. Consumers staple are things like food, toilet paper this kind of stuff. Consumer discretionary things like travels, leisure, clothes expensive things generally and you look at the relatively poor performing areas energy interestingly is falling in price in the US because gas literally becomes so plentiful because of hydraulic fracturing that the reality is gas prices in the US are the 3<sup>rd</sup> and a quarter of what they are in the rest of the world. In fact it's becoming enormous competitive advantage for the US there was an article in the economist one in Forbes magazine that it could produce a new American Renaissance. Literally companies that had move operation oversees are bringing them back to the US because in gas can be converted to plastics and other industrial feed stock it's now so cheap to produce because of fracking. Gerard Cruz: So, why was that such a political hot potato? Terry Dennison: There are some environmental issues what it involves is pushing primarily water into the ground and gas is in a shell which is kind of a rock it's called tight gas it's not just sitting there it's a little tiny holes in the rock and what they do they use water under high pressure to enlarge these to get the gas out and these are all over everywhere the big ones you hear are in North Dakota which is now called Saudi America. We are going to produce more energy than the Middle East by the end of this decade. There's also a lot of it in Apalasia which is kind of interesting because cold becomes bad for environmental reasons than just general issues here's an opportunity if you got gas you don't need to send guys down in a hole in the ground the issue is they have to inject some chemicals into the water because they have to lubricate the pumps and there's a question about whether this gets into the drinking water there was a movie that was made that talked about you want your drinking water to be flammable that's probably something that's going to get people. Gerard Cruz: There were commercials with lighting up ground, little wells. Terry Dennison: But, the reality is that this is such interesting to watch, I read European newspapers everyday because it's part of my job and it's interesting because there's this incredible tension Europeans are much more they think environmentally sensitive but now instead of paying Russians 6 or 7 or 8 dollars per thousand cubic feet for gas if you could just dig it out of a hole in the ground in your backyard for 2 dollars a thousand cubic feet. You start to wonder whether or not if you're on the right track so there's enormous pressure now, there's a lot of tight gas in the late district in the UK it's fairly well spread all over the world it's not just all in some place like the Middle East. Basically, anything you can produce at home you don't have to import which means you're not using currency you're not buying it from the Russian who can turn off the valve in half you want to freeze annoyed Putant. It turns the valve and you freeze I mean it's that simple that's where all the gas comes from, Europe. So, there's a lot of concern that the Europeans are going to fall behind because the Americans have such a cost advantage in terms of energy. And you're seeing a lot of electric plants now being converted to gas many are converted to gas produces about half the carbon-dioxide but rather than being primarily a cold based energy generation it's becoming more natural gas base. Gerard Cruz: I heard GPA is moving in that direction. Terry Dennison: One of the things that interesting is back when we were running short of energy we were building liquefied natural gas ports to import from people like Algeria. We are now exporting natural gas so that's going to produce a huge American Renaissance it is probably one of the few things we got going for us rather this is a fairly iconic image from the nautical lore, the ship and the squid. The squid is all the bad things and one of the really good things near the top natural gas boom is one of the things that may turn the US economy around.

I have to be slightly mindful about time, there's a lot of stuff want to cover in fact let's go to this Eye on the Market this is a Report from JP Morgan it's not suppose to go to retail investor's it's for institutional investor so I'm kind of cheating by giving it to you but there's a bunch of stuff I want you to see. This image is very iconic and classical image of a nautical lore and basically it's the challenge between two forces, the ship which we got something going for us what's on the sail. The US housing recovering is beginning to recover significantly in the US, the shadow of inventory of unsold and repossessed and real estate owned repo houses has been falling, house prices have leveled off or begun to rise. Lot of economist expect that US GDP is going to get an increase about 75 basis points or .75% of GDP from housing. Housing is a very potent part of GDP it employs a lot of people because houses primarily are still put together with sticks and nails, back when housing was booming unjustifiably so because of poor mortgage private lending but the reality is it probably added to 2% or 2½% of GDP in 2005-2006. It also accounts for about 2% of unemployment rate because all the people building houses are now not building houses.

We talked about the natural gas boom I'm just working down the mass. Equity evaluations with an interest rate lends. Equity Evaluations compared to bond returns are very attractive, equities are cheap when bonds yield almost nothing, yes there riskier than bonds but you are getting paid virtually nothing particularly for government bonds so the equity market is probably fairly valued at particularly if companies maintain their earnings. Corporate household walls of cash particularly corporations are just drowning in cash they've been borrowing because they could borrow cheap, they haven't been spending, haven't been adding factories, they haven't been adding employees they're just building up mounds of money. One of the thoughts is that at some point they're going to feel comfortable enough to reinvest that and now you're going to see more commercial investment, more capital expenditure so that's a positive. Even the household had significant deleverage themselves were previously household debt to income was debt to net worth, debt to assets was very poor we were up to eye balls in debt that now has come down. Some admittedly from default, some deliberately from bankruptcy, but people pull back they're not maxing out their credit card they're a little bit more frugal.

Basically federal government debt service the interest they pay is very low since they set the interest rate it's kind of convenient to be a big borrower. So, basically they have not only refinanced some of the debt at lower interest rates, they've also cut the duration of the debt they've reduce amount of long maturities that they sale and increase the amount of short maturities because obviously at any upward sloping yield curve the shorter length of the bond, the lower the interest rate. So the part of the treasury called the office of public debt that manages the debt portfolio have basically been trying to minimize interest expense by shortening the maturity of the bonds that they sale now the negative is when rates rise they going to feel that much more quickly. A lot of companies are selling 30 year debt even though they have to pay more because to pay the money back for 30 years. The Federal government has been shortening the average maturity of its debt portfolio down to about 3 years which means certain for 4, 4½ years which means every 4 1/2 years they would have to roll over the debt. Emerging Market consumption the big mass in the back if you look at Chinese retail sales actually going to chart of Chinese retail sales because it really matters now 30 years ago 20 years that would been laughable. But, it really matters now seeing



their spending rise concerns about a hard landing diminish they probably get a GDP rise of 7½ to 8 percent this year.

Some of the political uncertainties that exist of transition of power seem to have gone away and Chinese consumers are spending. Certain there's issues in China, I saw a report that listed about 15 very scary things about China in fact you've got municipalities that are basically running out of land to sale to finance itself and they've sold all land around them what's there next trick. Just continuing with this room to grow without inflation because across the develop world there's a term that the economist used called output gap. Output gap is the difference between theoretical GDP if everybody was working and the actual GDP there's output gap pretty much everywhere which means growth can increase up to that line and per thin theory and not generate inflation. So you can have quite a bit of none inflationary growth well that's a positive.

Central Banks have been very accommodating in terms of bringing down the cost of money and corporate cash flow corporate profitability is at multi decade highs. Corporations have done very well they kept their labor cost and supply change cost in hand that's part of the reason they're so profitable those are all the positives.

Now, let's look at the negatives. Spain balance payments crisis. We know that Spain is broke, they're broke internally but they're also broke externally they have a huge amount of external debt they have to rollover. Japans never ending growth swamp we talked about a 20 years, it's now been about 24 years. Doris Flores-Brooks: We use to talk about the lost decade. Terry Dennison: Now it's a lost 2½ decades, I could remember late 1980's back when there was bookstores you could go to the book store and look at the business section and there were shelves after shelves Japanese business model what we need to do to emulate the Japanese but good fortune that we didn't emulate the Japanese. It just shows the old Greek what happens when you become too proud, the universe swats you down.

China's capital spending over head much of the Chinese economy is not driven by consumer consumption which is actually healthy it's driven by capital spending. Building giant airports with no flights, building whole cities where nobody lives we've seen this ludicrous pictures the funny thing is they don't spend money on what they really need like roads that's how you end up with 65 mile long traffic jams. So, they basically they've been spending huge amount of their wealth building infrastructure but not the right infrastructure basically the Chinese save 20% of their income they don't spend very much unlikely like the economist here everyone had money but there was nothing in stores now there is plenty of things to buy they live in a world in the economy they can buy anything they want, but they don't they're still very frugal. Weak US labor incomes basically I have some statistics in here that the average family real income hasn't increase since 1995. Incomes have gone up nominally but inflation has eaten up all that gang so in terms of real income adjusted for inflation the average American household has no more money than they had in 1995. Realistically with outsourcing overseas and lower labor cost and the inability to basically in an economy where unemployment is very high enforce any kind of demands for higher wages the reality is there's not been a lot of wealth created outside of the famous 1% in the last 20 years. And it's interesting, I'll show you a chart that's actually in another thing we're going to look at and you think this is bad wait until we get to the

Hoisington paper because they got a slant on things. We tend to think that things are bad for the last 10 years the reality is the last time things were really good was the 1960's. I will show you a chart and if you believe the trend means something, if you see a line go like this you ought to be really worried, I will show you a line that goes like that and basically what it says is the growth period of America really ended 40 years ago. Wilfred Leon Guerrero: Ended 40 years ago. Terry Dennison: Ended 40 years ago, why don't I just take you there.

If you go to page 3, chart 3 the lower left hand corner this is real GDP this goes back to 1790's so it's actually a fairly lengthy time series this is real growth domestic product decadal annual growth so how much does GDP grow in a decade adjusted for inflation. Obviously the latter half of the 1940's when the wartime scarcity, the wartime rationing all of the service people coming back from the war able to get free financing for buying a house tremendous increase in household formation the thing went 6% growth. Then if you start to look at that line the bars are 10 years each historically the average GDP growth was little under 4%, the decade of the outs 2001-2010 GDP growth was under 2%. The decade before the 90's where they actually produce a budget surplus for the first and probably last time in our lifetime GDP growth a little above 3 and forget the 40's in fact I would start with the 60's because there's a lot of funny things that went on if we all remember the Eisenhower. Doris Flores-Brooks: The 40's was still the war. Terry Dennison: The 50's was the Eisenhower boom but it wasn't as robust as the 40's but if you look from the 60's on with one small exception every decade had a lower rate of growth on average than the prior decade and it's now down to less than half the historical average.

So, when we talk about a slowdown in growth economies potential for growth we're not talking here about a bad year or a recession these are decade long numbers. So when we talk about the ability of the economy to grow and everybody listen to the politician of every stripe, my stripe, your stripe the ones that look like a checker board the reality is that these economy just not going to be able to produce that growth, but will come back to Hoisington, this is one that I find very insightful.

But, lets continue on the OECD the develop market country now have debt to GDP over 100% and there's been a lot of academic studies Rhinehart and Rolf for sure had basically indicated the growth falls several percent a year when debt of GDP gets over 100%. Let me take you back to Hoisington just too really frighten you.

The chart to the other side, left I guess of the one we just looked at on page 3, this is debt held by the Public as oppose to debt held by the Federal Reserve is a percent of GDP this goes back literally to the period right after the signing of the Constitution 1790. And you can see that it blimp up in WWII, that little tiny blimp is WWII look at where that line is now and this is the congressional budget office forecast this is not some freak economist, it's not somebody with a political agenda this is more or less politically neutral congressional budget office. If you look at that line now somewhere around where that arrow is the country collapses, money becomes worthless. You look at that line 2085. I've said in this place and I've said at other places that we are the wealthiest generation this world would ever see but you look at these numbers this is simply there's a note above there that I've got underline when that law changes in Social Security and Medicare federal outlays would reach a staggering 40% of GDP literally 40% of the wealth created in the country would be

eaten by the entitlement programs. And the continuation of that and the last quote there of course this assumes the US government borrows funds to meet these obligations and that's when the game ends nobody will lend the money anymore. Let's continue on with this little chart here this is a very interesting report because it goes into detail there's literally detailed graphs and discussion about everyone of this points. Just the interest of time I'm not going to go beyond this cover but I would commend you look at some of these charts that talk about each one of these factors through here, you really get a sense of some of the positive and some of the negatives are going on.

Some more of the negative growing Franco German Gap, the French economy is slowing down dramatically its unemployment rate is over 11%. Germany is about 4½% you're seeing huge increases in unemployment factories being closed, people leaving country partly because of the taxes and partly frankly because of the very poor growth potential. Southern European unemployment 18% again in Spain and Portugal youth unemployment is over 50% whether or not any society can sustain that for any period time is highly questionable and the last one is a Pace of Iranian Nuclear enrichment Doris Flores-Brooks: I was surprised that was there. Terry Dennison: Well, all you need to really mess things up is the Nuclear War in the Middle East and there's a chart in here just to show you that they are not just dreaming this stuff up.

Let's look at page, the fourth page in, the first one with graphs. Basically what it shows its chart c12 the bottom right hand corner, basically what it shows is the minimum required for nuclear weapon production and what the projected time when they have enough spring this year is. What you got in this world is this tension between some positive factors and a lot of negatives factors become negative but I would commend you to take a look came out right after clearly is intended set the tone what they see, our money manager what they see to be the environment in the investment world this year.

We are expecting Global growth to be 2½ percent for 2013 half of the percent in the develop world. So literally the develop world is Europe and North American develop Asia primarily Australia and Japan would be half a percent no growth in a develop world a little over 4% in the emerging world. Obviously emerging world is China expect 7½ to 8%, India is struggling, Brazil is run of the rails, Russia is largely dependent on energy prices. Gerard Cruz: Brazil? I'm sorry. Terry Dennison: Brazil, if you take a look at the currency, the Brazilian Rahall is the second worse currency performance. They have to a degree an energy base economy also they produce ethanol with sugar cane, and they got a fairly decent oil based economy, there is oil off shore in Brazil and Petro Bros. which is the Brazilian state oil company has been a huge contributor to their work. Energy prices are down in real terms there down pretty substantially inflation is up 2½% in the U.S., oil prices are down in the U.S. so that spread is even larger. So, there's an analysis done that if you look at the BRIC country, Brazil, Russia, India and China, only China seems to have dodged fairly protracted period of slowing economic growth. The develop world XUS is zero so if you take the U.S. out of the Develop world its growth is nothing. And we still have people entering the labor force some of the countries that have the worst unemployment have very large youth populations. Again the social stress is significant. Merging World ex-China is only 2½ percent so it's basically the drivers of the world economy is the U.S. which isn't doing terrific and China. Global production has been slipping in a contraction everywhere,

contracting strongly in Japan, remember the Japanese economy is largely export oriented and until they have this big decline in our currency they were really being priced out of global market. Japan is contracting, their GDP is contracting in a 3% annual rate compounded. So, in 3 years there down more than 10% in terms of economic growth they were down worse than Italy. Italy is only down 2% because they're very susceptible to external demand when there buyers don't have money to buy they seriously struggle. Japanese growth is the worse of any developed major emerging economy in the world and this is why they're pretty desperate to see if they can inflate the currency. Part of the reason is Japan's largest trading partner is China and all this curve farfel about these ridiculous Islands in the south China's sea is having an impact. I mean basically if you know your history of course this place has a history like it the reality is the Chinese don't really care for the Japanese they have wrong memories so realistically it's tough when your trading partner hates you. We think that Global growth has improved perhaps slightly in the last couple of months and this has to do more with a bit of rebound from China and bit of rebound in the U.S. but remains below potential, we talked about potential growth which is full of employment and we are below that now, so there is this output gap.

One of the interesting comments in this book and I commend you to read this. They characterized what's going on with the tremendous impact of government deficit spending and central bank borrowing is the largest policy experiment in 300 years. So, we are living through an economic experiment is unprecedented in the last 300 years. Doris Flores-Brooks: Because of all the excess borrowing. Terry Dennison: In the U.S, Europe, Japan, and the UK government accounts for 75% of all borrowing and the Central Banks alone are doing 60% of all the borrowing. So nobody knows exactly (A) how this is going to work and something else we'll talk about when we get to the Hoisington, it's expected that with the new program the Fed is undertaken where there not only buying mortgage back securities they're tune up about \$40 billion dollars a month their now buying government debt straight government debt at about \$40 billion dollars a month with rollovers were things are maturing, they're going to add another trillion dollars to their balance sheet. Their balance sheet is going to grow to about \$4 trillion dollars before the crisis it was \$900 billion just level flat and all of a sudden it spiked to \$4 trillion. Now, there's no technical reason why they have to take it back down again, but the reality is to do that if they wanted to lower that they will be reducing the monies supply to bring their balance sheet down to at least what has been historically considered the right kind of number is going to be hugely depressive of the economy if they started to that you would have an instant major recession.

So, the question is can you have a Central Bank and the same thing is true with the European Central Bank and all the debt they have bought from countries the reality is this is an experiment they never had this much debt on the balance sheet of Central Banks around the world and to move it off would tremendously depress economic activity because they'll be pulling money out of the economy so that's another major issue.

The U.S. Conference Board which is a highly thought of Economic Research Organization called into question the whole BRIC concept we talked about Brazil, Russia, India, China that they've really picked the low hanging fruit of low labor cost. Labor cost in China are growing at 20% a year. The reality is there now pricing themselves out of a lot of markets in fact we're now seeing a lot of repatriation of things like call centers back to the U.S. because

it's actually cheaper to do it there. They have imported a lot of technologies which has improved their productivity well they have imported all the technology they need and there is. So, realistically their growth which has been tremendous and has been a support for the global economy is probably passed its peak and beginning to decline I mean the double digit growth we saw for a decade in China is history.

This is a conference board their prognosis for France is even worse it's trapped a depression a near zero growth out to 20-25 looking at more depressed growth. Britain would be unlikely to see GDP rise is about 1%, 1% is not enough to maintain unemployment levels. Again, the Chinese double digit expansion would be a romantic memory. Growth in India largely had been derailed they can't get rid of all the government bureaucracy and there infrastructure is terrible we joked about the infrastructure in China at least they build super highways, high speed railroads, India apparently built nothing you can still race the bullocks down the road.

We talked about the Squid, let's talk about the U.S. short term. Growth has been declining in the U.S. in fact most economist estimates for 2013 growth in the U.S. are about 1½%. Doris Flores-Brooks: Is that even below the 2 percent. Terry Dennison: Well, 1½ to 2 not above 2, in fact I saw a listing of various forecast and the forecast range is very narrow, though the article was entitled "The Consensus of Consensus". The consensus forecast are very tight the top forecast was 2.4, the bottom forecast was 1.4 and it was very dense between 1.8 and 2. The fiscal cliff did borrow growth from this quarter back into 4<sup>th</sup> quarter because people were basically trying to be tax increases. I didn't print it out but you can go on a website called calculated risk that's a source of that incredible graph that shows the recovery of unemployment. By this time in every recession after World War II we're above the high point in employment its [calculatedrisk.com](http://calculatedrisk.com) and the menu at the top and go to chart library and you can see this chart. We're still 3% below peak unemployment so in less than half the time it's taken us to get up from very high levels of unemployment up to worse level of unemployment of any post World War II recession we haven't even gotten up to the bottom of all the other lines everybody else was above the line. So, we now seem to have loss our vitality in terms being able to recover and remember that chart we looked at the Hoisington paper that basically GDP growth has been falling decade after decade since the 60's. Our ability to rebound business cycles are real, economic cycles are real the problem we have is we don't have the vitality to rebound. You know we are all older than before the lucky ones are and the reality is we're not as strong, were not as fit, we don't have the endurance, we don't have the strength we used to and that's perfectly natural, now we're human beings but we're also now seeing this in the economy, the economy has lost its ability to rebound.

We talked about this surge in corporate debt, corporate balance sheets have lots of cash well the 4<sup>th</sup> quarter they added to the pile. They borrowed to finance huge dividends, special dividend payments to beat the tax increase in dividends they said lots of money is good even more money is better so they build up huge war chest of capital. Now, there's an advantage to that. Wilfred Leon Guerrero: Why is that is it cheaper to borrow money to pay the dividends than just to pay the dividends. Terry Dennison: Right, because the taxation dividends went up from 15% to 35%. So, they said let's borrow actually the number was \$26 billion dollars, corporations borrowed \$26 billion dollars to pay special dividends

because from the shareholders perspective if they give you \$10,000 special dividend. Last year, you paid \$1,500 in tax if they give that to you this year you pay \$3,500 in tax so they said it's in our shareholders interest to minimize taxes, so we'll borrow this money which means they can deduct the interest rate the interest they pay on it so we can pay this special dividends that's why you saw these companies that pay 35 cents a quarter pay \$7.00 in the 4<sup>th</sup> quarter of last year or \$10.00.

Let's talk a little about this fiscal limits situation because Doris had asked about that. Doris Flores-Brooks: Yes, thank you. Terry Dennison: Here's the situation, actually the debt limit is a funny kind of thing realistically you could ask yourself why do we have one, we don't need one it doesn't serve any purpose other than it's a break against spending. Doris Flores-Brooks: Is a break. Terry Dennison: It's a break against spending. Doris Flores-Brooks: Our break is the 10% on real property then we get around it by doing other debt that's not counted against it that's how we do it. Terry Dennison: The Treasury is already hedging against this they're deferring maintenance transaction rolling over of debt in its own by Federal Employee Retirement Program (FERP) there's little games they can play the kind of keep the process. The debt limit actually became effective at the end of last year, but they can kind of monkey play with the game. By mid to late February they're out of game space they have played all of their games, March they believe the Treasury will start to prioritize payments, they'll pay debts because otherwise you'll have a default, they'll pay like social security in the like. Doris Flores-Brooks: But, that's been avoided because they passed, right. Terry Dennison: Yes, they pass this extension. Doris Flores-Brooks: Until, May. Terry Dennison: Just add two months to all these dates. April you would have to have a continuing resolution to support the government or it shuts down and then you've got this Sequestration issue. This is an issue that started in August of 2011 and very little has been done about what they're going to do about it. Defense contractors are already laying people off and shutting down projects so this is beginning to affect the real economy. The choices are limited besides the trillion dollar coin which would work but I think it will probably completely freak out the rating agencies. Doris Flores-Brooks: What is that? Terry Dennison: Somebody figured out that the treasury can mint precious metal coins in any amount so they were going to make a platinum coin the size of a manhole cover it would be worth a trillion dollars and the Federal Reserve would buy it and create money to pay for it. So, it's a way to basically avoid the debt limit. The Government has said they're not going to do that although it sounds hilarious this is what happens when you have a lot of lawyers. Doris Flores-Brooks: Are you kidding me. Terry Dennison: No, this is real it will actually work it just sends a bizarre message this is right up there with you cutting checks.

Another question is the 14<sup>th</sup> amendment and this is the issue of executive fiat the President simply say I'm going to ignore it and the citation is the 14<sup>th</sup> amendment says the validity of public debt of the U.S. authorized by law shall not be questioned that probably won't work, I'm not a constitutional lawyer but the issue here is not payment of the debt its incurring more debt so the 14<sup>th</sup> amendment actually doesn't apply. Realistically they're probably going to have to cut expenditures and raise taxes on everybody; they can make the numbers work. Doris Flores-Brooks: I said that too and I got crucified for my GRT. Terry Dennison: Realistically not to reprise the Romney campaign but this is going to have to include the 45% of people who don't pay taxes now and the reality is we are all going to contribute to this. Gerard Cruz: Everybody has to do it. Terry Dennison: They're going to have raise

taxes and cut spending, you can't just do one, and you can't make the numbers work. Doris Flores-Brooks: That's what I've been saying; one is not enough we can't cut our way to prosperity no way.

One of the best summaries I've ever seen. Doris Flores-Brooks: It's got to be a combination of both and the problem is we've done nothing, I'm sorry but this is more the Federal government now tell us. Terry Dennison: It's everywhere government, fill in the blank government. Doris Flores-Brooks: It was a joke sort of speak, when I guess the Republicans caved in on raising above the 450 but, how much is that going to bring. Terry Dennison: Nothing, the problem is we have to protect the middle class that's where the money is. If you raise taxes on the 1% to 100% soon you could collect it, which we can't because we don't have lawyers. The reality is it wouldn't solve the problem you've got to get to where the money is. Doris Flores-Brooks: But here's the psychological mind set of that at least they're contributing more. Terry Dennison: It's the feel good peak. One of the best analyses I ever heard is the U.S. has two problems the debt problem and the decision making problem. If you look at what the fiscal cliff answer was we will do what we all agree on and not do anything we disagree on that's basically what they did. Doris Flores-Brooks: We would do what? Terry Dennison: They didn't take any hard decisions. Doris Flores-Brooks: Right, nobody did. Terry Dennison: Nobody took any hard decisions basically they decided to do what they all agree upon, the Republicans gave a little bit on raising taxes and there's a few give up on both sides but the reality is they didn't do anything that they didn't agree on. Now, we are up against this dead issue because S&P last year downgraded the U.S. debt.

Doris Flores-Brooks: Then why is the market going up. Terry Dennison: But, Moody's and Fitch have said if there is not a clear sensible resolution not a band aid, not a kick the can there going to do it and the S&P was seen as being a little kind of out there when they cut it, when the other two cut it, it's going to have an impact. You're going to end up with certain kind of investors not being able to buy U.S. treasury debt because it doesn't meet their quality standards. We've been thinking about the decline in the value of sovereign debt around the world and we get a lot of our modeling is based on what is the risk free rate of return. What is the rate of return for the most risk less asset? We think now major multinational corporations that sale real products to real people around the world are probably safer bets than most government debt.

Doris Flores-Brooks: But, going back if you think of the world and where there was this chart where the U.S. flag was on top where else would countries put their money, I mean yes were bad, but everybody else is worse. Gerard Cruz: When the U.S. get ready to decrease the countries of Europe kind of went into a tailspin so where is everybody going to go. Doris Flores-Brooks: We're the best of the worst. Terry Dennison: If we weren't the world's reserve currency, we would be Greece. If countries didn't need to keep their reserve in dollars because US dollars still represent 70% maybe of Central Bank reserve, the Euro and few others in the rest if we weren't the world reserved currency we would be Greece we're just very lucky that we can export our problems to the rest of the world with some point the Chinese say no more we don't need you. The Chairman of the Joint Chief of Staff, Ed Momolan who worries about Iran and North Korea and all this other says our economic situation is the biggest strategic threat to the U.S. we've ever seen because our ability to

function as a world power is diminished if our economy isn't strong, we're a mess. Kind of interesting things talking about the Grand bargain they was a group put together Simpson Bowl. It was two former U.S. Senators, one from each party. Doris Flores-Brooks: You're talking about. Terry Dennison: The Grand Bargain to give you a sense of again going to where the money is. Doris Flores-Brooks: That went nowhere. Terry Dennison: I'll give you a sense of why it went nowhere, because in order to make any of this stuff work not only do you have to restrain the growth of entitlement, you have to raise taxes and the vehicle for raising taxes is to cut deductions.

Give you a sense of scale the biggest federal tax deduction is \$725 billion is employee health care tax deduction and second biggest is home mortgage interest and property tax deduction \$581 billion, capital gains and dividends rate \$456 billion, 401K tax deduction \$376 billion, earned income tax credit \$294 billion, defined benefit plan tax deduction \$264 million, charitable tax deduction \$186 billion.

If you are going to make any progress remember the Republicans wanted I am not saying there right but they're in some direction they won a trillion dollars in savings in 10 years and start adding these numbers and you would have to remove virtually all of this but a substantial portion of it no more tax deduction for your home mortgage, no more property tax deduction, no more tax free contribution to pension plans all of that has to go. Doris Flores-Brooks: I've being taken the standard deduction for so long, because my interest rate is so low. Gerard Cruz: We can change it. Terry Dennison: The reality is that this going to be the best of fix. I've a quote I'm a big fan of quote from famous people, George Washington in his farewell address said "The country should cherish the public debt preserve it by using it as little as possible and to not ungenerously throw upon posterity the burden which we ourselves ought to bare".

Last thing I want to go over a little bit of Hoisington is a very highly thought of, although not well known because they don't deal with retail market, they're a Investment Management firm all fixed income very interesting strategy that either entirely in 30 year treasuries or entirely in cash that is their entire investment strategy. Doris Flores-Brooks: What, but cash doesn't pay anything. Terry Dennison: Yes, except you feel the rates are going to rise and bond values are going to drop 20%, cash is really good. They put out quarterly, you can get this on the website [www.hoisington.com](http://www.hoisington.com), I am not advocating them as an organization but they do have interesting view and I was going to go over in the last 9 minutes.

On the 1<sup>st</sup> page they talk about the consequences of the fiscal cliff arrangement. They talk about something issues how the government makes decision. When the government evaluates the impact of proposed tax changes or regular card changes they used what's called a static analysis. They assume that you could change the tax rate and people's behavior won't change that if they were contributing \$10 thousand a year to charity and you reduce the charitable deductions and they will still do \$10 thousand dollars, or that people who have control over their income, how hard they work, sole proprietors alike you raise their taxes or work just as hard. The reality is economist has criticized us forever because behavior is changed by taxes if you have the ability to adjust your income or perhaps you move some overseas you will do that. I mean we see this now with the very



high tax rate in France Gerard daPeru decided to become a Russian citizen got his passport from Putin himself, the protest of 75% tax rate, he just left. A number of businesses and business leaders are leaving France because they just don't want to pay the taxes. So, that's what's wrong with static analysis but they talk about what the static analysis says is basically it's going to reduce GDP growth probably by about 1½% if you just use the static analysis.

Turn to page 2, talking about marginal tax rate we're now back marginal tax rates that weren't effect formatted in 1986. So we manage to ratchet the tax rates up and if you add the combined state and federal because the state has been raising taxes too. Taxes now in the number of states on marginal basis are over 50 percent. Doris Flores-Brooks: How much? Terry Dennison: 50 percent, the highest federal rate is 49. Doris Flores-Brooks: Okay, when you add them because the States are averaging 9-10. Terry Dennison: Yeah, you get a deduction unless you're wealthy the deduction is limited very complicated to calculate. But, the last time rates were raise to this degree was in 1937 and the recovery from the depression which had been taking place since from 34 to 36 fell back sharply their point B new raise taxes use depress the economy.

Then he talks about dynamic analysis when you take into a fact that people react to taxes, people react to change in regulation. And getting into something tax multiplier basically what happens to GDP growth if you raise taxes 1%, and he cites a number of economic analysis here in the upper left hand second column on page 2, the multiplier for permanent tax rate increase is strongly negative a minimum of minus 2, so if you raise taxes 1%, GDP growth goes down 2% over a 3 year period. If you are at 2% you're not on zero, if you're at 1½% you're in a mild recession, so tax increases have a very negative effect on growth. Particularly permanent tax increases the 2% we all got last year that went away the reality is that didn't change behavior very much you didn't spend that, you saved that. Temporary tax changes don't have much of an effect because people have longer planning arising, they'll save it or use it for other purposes they won't spend it.

Then he gets in on page 3 to the Entitlement Problem, now we've already looked at pieces on page 3 the Federal Debt held by the government is very, very scary chart if you ask me about real GDP, it basically shows that our ability to grow is diminishing dramatically this was the source if you go to the top on page 4 to the observation at real median household income is at the lowest level since 1995. That's not a recipe for significant economic growth. Percentage of people age 25-34 living at their parent's home is at a record high. Doris Flores-Brooks: There was something I saw the other day, people are adding from the grandparents, parent, it's now three generation living under one household. Terry Dennison: And probably the creepiest statistic I've read in awhile. Doris Flores-Brooks: And that's what's contributing to the housing boom, that's what they're saying. Terry Dennison: One out of every 6.5 Americans are getting food stamps. Doris Flores-Brooks: Guam is approaching a 100 million dollars in food stamps, its \$90 some million right now, I remember when it used to be \$60 million it's now up to \$90 million. Wilfred Leon Guerrero: What is the percentage? 25 percent. Doris Flores-Brooks: I don't know, in just gross dollars its \$90 some million dollars. Paula Blas: That's not a hundred percent federally funded. Doris Flores-Brooks: It is. Gerard Cruz: I've seen signs of abuse that just go on this lady buys sacks of rice.

Doris Flores-Brooks: Anyways, but that's the abuse there and look at the unemployment compensation in the U.S., Fed-X and companies like that couldn't hire because people didn't want and said it wasn't worth it and I can collect my unemployment insurance. Terry Dennison: I'll give you another factor in real life, I have a friend of mine for 62 years he lives in Green Bay, Wisconsin, he has his own business, lives by himself, eats McDonald's three meals a day because he likes it, he's befriended the manager of McDonald's and discovered that she seems to be there from the moment they open until they close and he said why don't you hire some more help and she said we can't find anybody to pass the drug test. That's becoming a significant issue for unemployment that if most employers requiring a drug test most of these people can't pass it, they would hire people. There was an article in the Economist about problems with U.S. education, I think it was in Ohio a town that has a very high unemployment rate and a huge number of open jobs the problem is the open jobs are for skill machinist who know how to work computer control machine tools and the people without jobs can pick up heavy things that's their skill and so the company is looking at perhaps thinking of moving to another place where they got a more educated work force. Finally, the local community college is now beginning to teach some of these skills that you need to get a job in our present economic environment, stop teaching basket weaving and start teaching how to run a machine tool.

The last statistic here again I don't want to reprise the Romney campaign but the percentage of U.S. household paying Federal income taxes have fallen to an all time low. They start on their strategy on right hand column page 4, left column page 5 is very chilling reading. Last thing I'm going to do is talk about. Doris Flores-Brooks: So, where should we invest? Terry Dennison: Not obvious choices. Doris Flores-Brooks: Like you were saying multi-national corporations. Terry Dennison: That is not necessarily a good investment it is a good measure of risk free rate of return.

Page 7, lower right hand graph Federal Balance Sheet and Bank Excessive Reserves the blue line is a Fed balance sheet you can see back before the financial crisis it was \$900 billion for years see how much that has grown because of course the government was borrowing money. Doris Flores-Brooks: That was the toxic assets they bought and things like that. Terry Dennison: It was toxic assets, its financing a lot of these programs right now they're buying not net of maturities \$80 billion dollars of bonds a month their expecting to see that balance sheet grow another trillion dollars. Like I said before if they wanted to and there's no technical reason or legal reason but my guess is to have this much money in the Central Bank is probably got undesirably economic impacts if they started to push this down you would have the money supply get very tight, you see interest rate soar, you see the economy slow down a lot.

Turn to page 8, the two graphs the top one Annual GDP Growth and this is going back to 1980 but you can see even for this little graph the fact that GDP growth has been trending down and down. So then again you need about 2½ percent GDP growth under ordinary circumstances to maintain unemployment. The bottom graph is interesting because the red line is the unemployment rate and you can see it shot up with the economic crisis and has been dribbling down. The thing that's interesting is the blue line which is the percent of the working age population it defines 18-65 that is in work and that scale is on the left

and you can see that it's been drifting down and has not improved. So you can look at these two lines and explain the decline in unemployment it's not the people getting jobs it's there permanently leaving the work force. So, it's not creating any wealth whether you are unemployed or left the labor force you are not contributing to economic growth. Doris Flores-Brooks: But, they left the labor force because. Terry Dennison: They can't get a job, they give up. Doris Flores-Brooks: Not because they retired. Terry Dennison: It's a definitional finding, they involuntarily retired.

Page 9, lower left hand side the Case-Shiller Housing Index this is a positive factor you can see that it's leveled out this is a 10 City index of housing prices you can see how much of that bubble has been retreated from but now the house prices seem to be fairly stable.

Page 10, lower right hand graph these are consensus estimates of GDP growth for this year. One of the things that's interesting is with the exception of the U.S. where estimates come down from 3 to 2 all the other estimates have come down dramatically from the 2½ down to the 1 1/4 to 1, minus for Euro land. So literally every single time they took a picture of the consensus of GDP forecast those numbers were down.

Turn to page 13. Antolina Leon Guerrero: Consensus GDP what is that? Terry Dennison: They survey 30 or 40 different economic forecasting organizations, banks, brokerage firms. If the upper right hand corner this is a little technical this is a cost of one year put option for protection beyond the 20% loss it's the markets forecast of the likelihood of a loss of greater than 20%, losses of greater than 20% in the stock market occur 6% of the time basically one year out of about every 14. The market is now pricing options for that to be double that probability 1 year out of 8. So, the market is forecasting a double still not a high probability of a 20% loss in stock market, but it is a double the typical rate. Another thing that would be very worrisome for investors is the lower left hand graph the real expected returns on bonds and stocks. You can back out from pricing of bonds and stocks what the market is forecasting the returns to be and if you look at the balloon on the left current interest rates at equity evaluation suggest a 60-40 portfolio, 60% stocks and 40% bonds is price to provide a long term real return of only 2.3%.

Doris Flores-Brooks: What age will that be? Oh, this is for overall. Terry Dennison: Yes. Real return of 2.3% for that 60-40 mix right now inflation is a little over 2 so that's a 4% maybe 4½% return for a typical investment portfolio. Now reflect on not your Fund but Public Retirement Fund in general expected earning rate. You're a big problem on a small Island, you look at PERS and STERS and all these giant pension funds. Illinois is not just going to become severely underfunded there going to run out of money before the end of this decade. Doris Flores-Brooks: The state of Illinois. Terry Dennison: Illinois teachers and Illinois Municipal will run out of money the tilt will be empty. Doris Flores-Brooks: They'll be like CNMI, but they're not doing anything or are they, because I read something where Wisconsin went back and did. Terry Dennison: Wisconsin is nearly 100% funded, about 98% funded. Doris Flores-Brooks: Wisconsin because we were just there last year and they talked about what they did. Terry Dennison: They're virtually fully funded what they did is that they didn't make promises without funding. That's how Illinois got into trouble, Illinois said okay we'll raise everybody's pension and didn't put any money into the Fund. But if they expect to earn their way out of the hole 4½% is what the market is

saying you get a nominal returns, adjusted for inflation there if your benefits index are inflation with a real return 2.3%. Doris Flores-Brooks: But, what is the contribution rate in the State of Illinois? Terry Dennison: I have no idea. Doris Flores-Brooks: California is supposed to be slightly better than Illinois. Terry Dennison: Actually, the Government may be running a fiscal neutral budget because of Prop 30 and the economy has improved a lot. The beta on 100 thousand tax payers who provide virtually all the money is very high and that 100 thousand tax payers who provide all of the money and the other 39 million just watch has done very well and the reality is that the last I saw which was couple of days ago is the statement come in as almost being neutral. Gerard Cruz: Really. Terry Dennison: They got a much more dynamic economy. The problem in Illinois is that everybody is leaving. If you had money why would you stay in Illinois? Doris Flores-Brooks: Only Oprah does. Terry Dennison: I would be willing to bet her tax home is Nevada, Florida, or Texas one of the 3. Anybody with money is not going to be in Illinois, New York, New Jersey, Pennsylvania, or California. I think that's all I really have time for because I want to keep you on schedule. Did I use your time wisely? Attendees: Yes.

Let's go back to the plastic cover book some of this is for the record, if you go to page 11. For those of you who have been here for a long time we look at the Option Array again we think you have a very broad of range of options you've allowed the participants to latitude they have to construct portfolio suited to the risk of return characteristics. You have some good option in terms of things like the inflation protected funds if inflation ever comes back. You got an International bond fund that gives your participants a fixed income fund that's not based in the U.S interest rate and US economy.

If you turn to page 12, just taking a summary despite the fact the market was more or less flattish we did see some increase obviously contributions are still being made the funds up to almost \$300 hundred million dollars at the end of December. The 401A Plan, 457 is passed \$25 million up to \$27.3 million at the end of the year. Both of these pretty healthy increases from the other market value in terms of plan summary we go through each one of the funds, there are a couple of changes from last time. Basically you've got a good set of funds there really isn't any real weak strongly bad a funny way to say it.

### **DC Plan Performance**

But, let me take you to page 15 and we're making a recommendation to place them on watch both the Franklin Small-Mid Growth Fund and Barron Small Cap Fund for quite different reasons. The Franklin Fund which we talked about for last several quarters is certainly a laggard in terms of performance. While we still like their process they seem to not be able to in any market environment that we've seen be able to produce particularly strong returns. There trailing the Universe median for all periods except the quarter they showed a slight improvement up to the 47th percentile. Remember I talked about the sectors that did well industrials, materials and financials they were under weighted in all of them so they weren't exactly in the wrong place. It's like how can you be so wrong, it's not a question how you can be so right, it literally hit exactly the three that's why I mentioned them earlier and it's consistently underperformed the growth index now going back 15 quarters. It's a discipline structure it's not terrible, but I think the point of doing this. Doris Flores-Brooks: Is that 15 quarters? Terry Dennison: 15 quarters, the point of

doing this, is partly to demonstrate a concern on the part of the committee that this Fund ought to be watched and basically if we don't see significant improvement probably in the next quarter or two it ought to be replaced. Antolina Leon Guerrero: The strategy is still a valid strategy, it just doesn't work for 15 quarters. Terry Dennison: Yeah. Paula Blas: They're underperforming the benchmark. Gerard Cruz: The manager is, so we need to look for a new manager. Terry Dennison: We need a small to mid cap growth fund so what we be doing is replacing it. Antolina Leon Guerrero: I thought you were saying that the Franklin strategy is, the way that they approach and manage. Terry Dennison: They approach, we like the way they invest but that's fine it's just when they execute it. Their approach to investing is sound there execution isn't working well. Doris has a question of why not bang right now? and my concern is we had a great year last year the market was up 15 percent the economy was seem to be improving we talked about all the slowdowns all the things that could be negative. The trouble with picking, it's easy to say get rid of them but you're also going to hire somebody. So, it's not one decision it's always two decision and the trick is you can get whipped sawed and you can fire the people who have been doing badly for the last 15 quarters and hire the people who had been doing great for the last three years just at the time the market psychology changes, so when I say they're not doing terribly they're underperforming, I mean they're disappointing us.

The question is when we get to one of this reflection points, if I knew for a fact that 2013 was going to be good as 2012 I'd say we ought to find somebody better, but we went from an economy that was growing at 4% in the first quarter, to an economy that's probably grown 1½% in the 4<sup>th</sup> quarter and where most forecasters are only 2% for the full year. The question is are we able to find somebody who isn't going to be doing what worked last year into a year that's very different. So, that's why I'm not quick on the draw because again you have to make a second decision and we're in a period where my crystal ball it's an old black and white model and it hasn't worked in a while I can't find anybody to fix it. It seems particularly hazy today because of all of these factors.

So, what you've done is if you proceed with this you have indicated to posterity which we have to be worried about we have indicated a posterity that we're now concern about this and we might take action if circumstances are appropriate. Do not put it on the watch in the face of 15 quarters of bad performance including a number of different market environments, could raise question on how diligence you are so that's how we're doing it. The second one is a trickier one because the Baron Small Cap Fund has been doing really well so this one I guess you could call and I know this is on the record. There's sort of like two watches, there's watch one and watch two. Watch one is we're not really happy with the performance and we're worried about it, and watch two is the performance is okay but the Fund has become enormously large there's a discussion in here about the size of the fund I think it's getting up to about \$5 billion which is very large for a Small Cap fund. Because two things happen when you have that much money in a Small Cap either you have to have a lot of names a lot of stocks because if you are buying stocks with a market capital of a billion which is the general definition of a Small Cap and you don't want to own more than 5% of the company which is a good rule you don't want to own a company for legal reason you own more than 10% what is call liquidity how long it take you to get out, how many days of trading will take you to get out of your position, you don't want to own 5%. Well, if you got a billion dollar company you can only own 50 million dollars of it

and you have a \$5 billion dollar fund you're earning a hundred stocks. Do you really have a hundred good ideas?

The other thing that can be bad is and this is what happened they have a stock in here that's got a market cap of 20 billion dollars. It started out small it's been extremely successful, Portfolio managers don't like to sell their winners if it keeps making money why sell it. Well, that makes sense except this is a Small Cap fund. We have advertised to our participants that this fund invests in small companies and yes it's great for the fund that this stock has grown from 500 million to 20 billion but the reality is it's no longer small cap it's well in the large cap range. So we start to run in the truth in advertising issue so there's a lengthy discussion including complete research note expressing the concerns about the size of the asset. Do I have a cock pistol like one bad move and bang, no. But the reality is there's a lot of funds like this you know a lot of the Capital Guardian Funds, Growth Fund of America, Euro Pacific Growth Fund are enormously large and they basically become Index Funds that they end up owning the market because they have so much money there's no place else but own the market. So, you're paying active management fees for what amounts to an Index Fund. So, the concern here is not about performance they also have no guidelines saying let the fund so big and no bigger. One thing that we as consultants like are Managers who put your interest ahead of their interest. Your interest is making money from the participants; their interest is making money for themselves. If they let the fund get big they get rich and your participants don't do as well. So, we think very highly of managers who say we will let the fund get this big and no bigger because that's saying we will take money, not take money out of our pocket, but not put more money in our pocket to make sure that our investors, your participants get a good deal. Basically they sort of weasel out of this they don't have a guideline making a limit their guideline is when we think it gets too big to execute the strategy, we'll stop. So, these two we suggest putting on watch, one for performance and one for size.

Turn to page 17, there are news items some of them really quite interesting none of which I consider worrisome but you should just for due diligence at least skim the strategy. The quote from the manager Baron Fund – indicated that the fund remains open to new investors and there is no stated capacity level he anticipates closing the fund like he's done temporarily in the past he is unable to effectively execute his strategy. So, if he no longer can make money for you, he will turn off the valve.

Go to page 21, 22, 23, 24, 25, 26 these are the usual summary grabs basically the easy thing is nothing happens because this is a participant directive fund changes are glacial there's little tiny wiggles and it appears to be no clear trend. Page 26, gives you the summary.

Go to page 27, looking at fees generally your participants are getting pretty good deals on fees. The Maxim Funds are really exceptional but there not even paying this because the fee doesn't kick in for awhile. The only ones that are nominally in my mind are Baron which is expensive at 27 basis points above the median. Champlain but their performance has been pretty good so the performance is all net of fees. Some of them are really outstanding the Winslow Fund is very inexpensive compared to the median and obviously

DFA because of its business model is also a screaming deal, Emerging Markets which has been a good place to invest for 67 basis points for the median expense ratio funds are 121.

The compliance table is on page 28, one problem with this kind of presentation is you can sometime be led astray because you get the Red X if you don't make the target exactly. If you go for example look at the Black Rock Funds a lot of Red X's. Go to page 31 you get a very different picture in some cases they missed it by 10 basis points or basically it was rounding error. There's things here like 50 seconds percentile well that's below the median you get the Red X for that. But, the reality is if you look at it when they're good, they're pretty darn good and when they're bad they're not terrible. For example for 5 years for the Institutional Portfolio of BlackRock on bottom page 30 they missed it by 10 basis point, they got a Red X for 5 years by missing it for 10 basis points they were 4.4 versus a 4.5. So, I wouldn't do anything because I think they're doing fine.

Page 29, you can see that we had one quarter worth of wobble with the Windsor II Fund that Red X has only been there for one quarter and the Red X for the Winslow Fund for Index Performance is only been there 1 quarter, the bottom 3 funds are green checks all across you can see Franklin has just not done very well. Although it's only the 5 year Index return where they have been below are guidelines for a long period. The 3 year numbers is only 5 quarters and 3 quarters and for the 5 year Universe performance it's only 3 quarters.

There's detail starting on page 30 of all the performance numbers. Wilfred Leon Guerrero: Let's look at BlackRock LifePath can you explain like the return for 3 years is 7.3 and 5 years 4.5 and 10 years is 5.8 and for 1 year is 8.6, the ten years here is annualized and how do you come up to 8.6 or am I reading this. Terry Dennison: The one year performance which will be the year of 2012 and the 3 years is 2010, 2011 and 2012 these are cumulative returns. But, the cumulative returns, the returns longer than one year are annualized so it's been broken in to yearly returns so that there all comparable, because if I gave you a 5 year on annualized return you would have to work it out in your head to figure out how did that work. I'll be happy to address any specific numbers but that is the summary and the recommended actions and I refund 60 seconds to your life.

Paula Blas: Doris here's your flags. Doris Flores-Brooks: Second one was Britain. Who's the red, oh France, I was surprise that Spain was even there. The reserve currency because going back when you said we're the best of the worst, I was surprised that the country like Australia or even Germany was not there. Terry Dennison: Remember Germany is in the Euro so after 2003 they wouldn't be on here. Doris Flores-Brooks: But, why France, Spain. Terry Dennison: Well if you think about their history I mean look at these dates. Doris Flores-Brooks: Oh, that's when they hit their peak, okay I got it. Terry Dennison: Spain was the riches country in the world because they got the part of it that was all full of gold. Doris Flores-Brooks: So, the next question is who's going to replace us, right. Who's going to replace the U.S.

Terry Dennison: There's only one candidate and they have other problems. The issue with China is will they get rich before they get old. They have a huge demographic problem because of the effect of the one child policy. There going to run out of workers it sounds

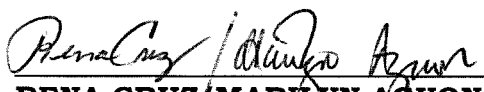
like an absurd statement how can the most populist country in the world run out of workers. Paula Blas: You would have to look 20 years. Doris Flores-Brooks: But, speaking of population the other thing I've been reading about or hearing about is the growth of the world population to sustain the world, I didn't hear anything or is that further down.

Terry Dennison: The global population is slowing everywhere except Southern Sahara in Africa. Basically, it's below replacement rate in Europe about replacement rate 2.1 live births per woman of child bearing age. The reality is we're below replacement age in Europe, dramatically below replacement age in Japan and won't be any Japanese in 100 years, the population will fall. The Italian population is falling the funny thing about it is people become wealthier their children per woman drops that's why Africa is so high, Africa families of 8 or 10 are not uncommon. But, even in China now with the child policy is artificially reduced but the effect of that is if you want a worker 20 years from now they have to be alive today. So, the reality is that demographics is very important, I mean demographic is destiny, realistically if you look at the problems in the U.S. long term its debts deficit demographics.

Wilfred Leon Guerrero: You don't see any unrest coming up in China when people become poverty because of their wealth. Terry Dennison: Oh yeah, if you look at a lot of the geo political commentary question of what happens when it's not as great as they got use to being? In 2 generations they've gone from pulling a plow by hand to driving a Mercedes on a six lane highway. What if doesn't look like they're going to continue to go that way? The other question is will the political system survive? When Don Shaw Pain became Premier he's the guy that said our policies get rich and the four modernizations. Somebody said what about the fifth modernization, democracy. There's now a block of fear there. There is a current of unrest and of course the internet they're trying to control the internet, but the internet is fundamentally in control. So, I think there are potential issues and I was just reading the Economist on the way over here, there's now getting to be some very scary stuff going on about these ridiculous islands. There could be a war I mean it will be real easy to start one, the Chinese are spoiling for it. And you've got a new nationalist government in Japan who denies a lot of things that were done in World War II who freely goes to the Yakisoni shrine to raging everybody in this part of the world. The reality is you've got a very inflammatory situation and it wouldn't take much, it's not a nuclear exchange but you can end up gun bolt shooting at each other.

**Respectfully Submitted:**

**Affirmed:**

  
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