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**Quarter Ended June 30, 2014 Performance Meetings  
& Annual Investment Manager Reviews**

September 26, 2014

Retirement Fund Conference Room

**Board of Trustees Present:**

Joe T. San Agustin, Chairman, Board of Trustees  
Wilfred P. Leon Guerrero, Ed.D, Chairman, Investment Committee  
Gerard A. Cruz, Trustee  
David M. O'Brien, Trustee  
Anthony C. Blaz, Trustee

**Staff Present:**

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

**Other Present:**

Maggie Ralbovsky, Wilshire  
Doris Flores-Brooks, Office of Public Accountability

**Economic and Capital Market Environment  
& DB Plan Performance**

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## **Economic and Capital Market Environment & DB Plan Performance**

Maggie Ralbovsky: Good morning. I'm going to start with the market update, tab number 1. The second quarter as well as year to date have been very good for risky asset classes. On page 3, you can see on the top panel we have the performance for all the different sectors of U.S. equity and on the bottom panel we have the performance for international equity and you can see the stocks around the world had very strong returns especially emerging market. Look at emerging market out performed developed markets as well as U.S. market for the quarter. And look at Frontier market, Frontier market had double digit returns for the quarter year to date was 20% upside. Now all these were encouraged by the loose money policy by the central banks around the world. So not only the U.S. Fed has been keeping interest rate very low but also Japan. Japan joined the effort of printing money started last year and most recently beginning of this year European Union also started this effort. So the European Union central banks governor named Mario Draghi and he has changed their historical very disappoint anti-inflation stands, he has changed that tone entirely. He has made it clear to the market. He's going to do whatever it takes to prevent deflation so the sound has changed from inflation to deflation and that's one reason interest rate has dropped significantly in Germany.

As of the close of 2<sup>nd</sup> quarter Germany 10-year treasury the German version of it was trading at 0.9% and compare that to the U.S. treasury closed last year at 3% so when the market saw that coming they didn't care what the Fed was going to do. Interest rate has continued to drop in the U.S. because if you think Germany is trading at 0.9% what is the rationale for those to have such a great gap? So the gap has been closing and that's one reason that surprised the market because everybody was thinking U.S. interest rate will go up but actually went down, went down significantly because of this arbitrage trade around the world. And that is another reason offered by some part of the market who say hey we don't think even when Fed raises rates, the 10 year treasury or longer term treasury rates are going to go up. Because there's this lid on top of all the different developed markets. There's arbitrageurs out there we can always borrow at Germany's rate and buy U.S. rate and get this differential. So there is a force out there to push them long term rates. And also interestingly even Spain and Italy their 10 year rates are below U.S. 10 year rates. Now those are the crappy credit compared to the U. S. So there is a lot of force out there to push down the longer term interest rate.

David O'Brien: But fundamentally what would the rates be? Maggie Ralbovsky: So there is somebody who offered. David O'Brien: Aside from. Maggie Ralbovsky: Yes, so there is a person offered a calculation to say, what should be the neutral rate? Now, the neutral rate comes up to be a function in between unemployment rate plus the capacity slack in the market plus the growth rate. Now if you use his formula U.S. Fed's funds rate today should be 3%. So Fed funds should be 3% which is cash rate and then the 10 year treasury should have like 2 percentage points spread above that. So 10 year treasury should be at 5%. So based on the neutral calculation thinking U.S. is in an isolation that should be the neutral rate. But U.S. is not in an isolation, it lives in this world where everybody still has problems to solve. So we think secularly there is a good reason why the longer term rates can stay low. Now short term rates on the other hand is controlled directly by the Feds and the Feds have made it clear that they're not raising interest rates for a foreseeable future which the market interprets toward the middle or end of 2015. So, status quo until then.

So in fixed income market, you can see page 4 is also very positive because interest rate has been falling which the consequence of all these rallying is to mortgage the future. So if you think about we had such great returns for the past, what has to give? It's the future expected return. So if you look at starting from page 5, we're providing some perspective as to what we think the future may hold for us when the interest rate is dropping like this you see the cash rate. Let me explain this chart first. The top chart says cash versus 10 year breakeven. 10 year break even is inflation as forecasted by the market in the next 10 years. So this 10 year breakeven is the inflation so we ran a rolling 10 year average compared cash yield versus inflation, the differential is graphed on this chart. So if you look at the yellow line, that is the markets average pricing for cash over inflation. David O'Brien: What yellow line? Maggie Ralbovsky: The orange line, sorry. Maggie Ralbovsky: Orange/yellow line, that's the ruling 10 year average of the differential. So on average you can see historically the market is giving cash 1% return above inflation, so investing cash you're supposed to get something at least compensate you above inflation. Now, that average has been dropping to close to zero however if you look at today's pricing, cash is the dark blue line. That is after the bottom 10<sup>th</sup> percentile. Does that make sense? So, not only it's not compensating the investor for inflation but also if you stay in cash you're basically contributing 2½% to whomever is borrowing you know it transfers well from savers to borrowers and borrowers have tremendously rewarded in this kind of environment and that is why all the risky assets are rallying the more risk you take the higher the rally you get. Because of this phenomenon of transferring well you're subsidized by people who are saving money basically.

Maggie Ralbovsky: Now if you move forward to the next page which has similar information of fixed income market, the top chart shows you high grade fixed income. Now, high grade fixed income compared to historical averages is also trading below 25<sup>th</sup> percentile. So compared to historical averages high grade credit is more expensive than 75% of time in history and high yield similarly is actually trading at 18<sup>th</sup> percentile so this is an average in terms of yield only. Now high yield on the other hand we have heard from managers as well today's default rate is historically low so you have a case we made to say the spread is low but default rate is very, very low, and there is no default in sight because all the low interest rate has helped the company refinance their debt pushed back to another 10 years. Most of the time high yield companies default was because they couldn't borrow to roll over their debt, now that horizon has been pushed back so far into the future that's why this fundamental is supporting this kind of a spread of very low. But that being said still the valuation wise very expensive. Now U.S. equity same thing, so the dividend yield by itself so this is the opposite of the PE ratio it's the EP ratio, the EP ratio the higher the more expensive. So you can see that U.S. treasury, the U.S. equity purely by dividend yield is expensive and compare that to treasury yield which is actually more telling on the bottom chart on the left hand side. This is the EP ratio compared to 10 year treasury, so if you think about with the differential is to compensate people for the risk they're taking for equities, the EP ratio is supposed to be trading close to that orange line. So when it's close to that zero line that's when it gets really expensive. So compared to historical averages equity is expensive, fixed income is expensive, cash is the most expensive. So it really is not something you can say hey its expensive lets take the money off the table because everything is expensive it's comparatively to history is expensive. So opportunity cost wise it's really hard to say which way you should go, so I think the best answer is still diversification, you'd pretty much have to spread your money around.

Maggie Ralbovsky: Okay, so compared to U.S. equity and the different segments of equity market page 8, we also have a graph the differences it's very hard to make a case for any of these sectors to say they are cheaper than other sectors with the exception of the developed markets versus the emerging market. So that's the bottom chart you see non U.S. developed markets to emerging market that's the only blue line that's actually showing relatively cheap. All the other segments are very much towards the average. So by this measure of developed markets is the cheapest right now because the sell of in Europe people fear driven selling. Okay, so just a quick recap that the risky assets all rallied around the world because of the central banks liquidating injection to the market, that has also caused future expected return to drop because we have pretty much mortgaged the future to today. Now, however there is this debate on long term interest rates, I have highlighted a little earlier that there's fundamental forces to push down the long term interest rate. Now secularly speaking there's also forces in the real economy that pushes down the interest rate in the long run.

The first one being the aging of the population and here's a chart that's basically saying secularly speaking the entire world is aging especially developed markets and here's the percentage of population above 60 years of age in developed markets is forecasted to be across 30% by the year 2050. Now what does that mean to the investing world? When people get older they tend to seek income not seeking growth so you have the mass transition from risky assets into income generating assets which may keep the interest rate low because the demand is high to buy the yielding assets which is fixed income. Another force out there is the innovation now this is a few charts on how fast machinery is replacing people. So by some calculation in 20 years 30% of the jobs today performed by humans will be performed by robots which include McDonalds. McDonalds is actually testing hamburger machine, that machine is pretty much could be in production so if this force of pushing minimum wage and health care cost arising, if all these are accelerating, theoretically McDonalds could replace most of their people with robots.

Now that is same thing is true with healthcare industry, the testing the blood testing the different flu testing in hospitals today can all be replaced with robots. Actually the lab corporation has already successfully tested these local robots that can do all the testing. So by certain measuring 20 years 30% of the jobs can be replaced by robots. Now what does that do? That means there's going to be a huge population that's going to be moved to rely on taxpayer dollar to be supported you know to support them which does not go well for growth because when you have more assets to be used for consumption you have less assets to be invested for the future. David O'Brien: But that doesn't make any sense because as the demographics of the workplace you know it's clear that when the boomer generation moves out. Doris Flores-Brooks: That's me. David O'Brien: You know that whose going to fill those jobs there's not enough. Maggie Ralbovsky: Robots. David O'Brien: Yeah, exactly so that's good so if you're going to maintain growth you have to have someone doing those jobs. It's either genX and genY and Z or whatever they are plus the robot. So growth has to have something. Maggie Ralbovsky: Well okay look when you talk about shorter term versus longer term there's a lot of differences out there. The calculation here you can see the middle chart basically graphs the probability of certain trades being replaced. So you can make a case to say certain jobs will never go away of course especially service oriented jobs and human oriented jobs probably will never go away. Doris Flores-Brooks: Like auditing. Maggie Ralbovsky: There might be a machine. David O'Brien: Are you kidding just put in

the transactions and spits it out. Maggie Ralbovsky: Little robots running around. So the adoption rate this first chart is saying how fast the adoption rate so it really is the entire technological advances have been so dramatic that there is this fundamental pressure on longer term interest rate. So that's what this chart is trying to say.

Doris Flores-Brooks: Can we go back to this chart if you don't mind, this is the first time I'm hearing this type of conversation. So to read this chart here there is a low probability a 33% of the jobs will be replaced and then, how do I read this 33, 19 and 47 how do I read that? Maggie Ralbovsky: This is to say that there is a 33% of the employment opportunities in this in these categories have a low probability of being replaced by computerization. On the right hand side. Doris Flores-Brooks: So education, legal, community services. Maggie Ralbovsky: On the right hand side 47% of these jobs in these trades have a very high probability of being replaced by computers. Doris Flores-Brooks: Office and administrative support okay, I see. Maggie Ralbovsky: Farming, fishing. Doris Flores-Brooks: Okay, alright. So depending on, see legal will never be computerized. David O'Brien: Too bad. Doris Flores-Brooks: Although what is happening though is the research is so much easier now and the researching of finding things and maybe that's where and that's found in industry. And the work you do will never be although more and more relying on trading and stuff like that, right.

Maggie Ralbovsky: Yeah you're going to have a robot come here and give you a report. Doris Flores-Brooks: I can see where a robot can give you the history. You know and give you all that and then you can come in and make your judgment, I can see that. You know that aspect being done robotically to research like data and stuff like that. Maggie Ralbovsky: Well the portfolio manager will come with a sales person who is a robot. But the sales person will be telling you about what the company is about the robot will be used as a data base. Doris Flores-Brooks: Okay, thank you. Maggie Ralbovsky: Okay, the next page is talking about... Doris Flores-Brooks: I apologize. Over what period is this? Maggie Ralbovsky: So, secular speaking they are talking about 20-30 years. Doris Flores-Brooks: Over the next 20-30 years, okay. Maggie Ralbovsky: So then there's a deflationary influences which is to say that certain things simply do not have an ability to become inflationary. So look at bottom left hand chart, these are the products that have massive deflation because these are the products that actually have something called disintermediation plus commoditization. So the disintermediation means that there is a lower demand because they are being replaced by other things. So there is a replacement of other things going on for example video tapes, who uses those anymore and who knows if Iphone is going to be obsolete one day. So there's a lot of these kinds of a technological advances that replaces old technology and this you know Kodak is no longer a company that is viable. In L.A. they have to change the name of the Kodak center for Oscars and Oscar has been held the academy award ceremony had to be held in Kodak center but they felt like they are associated with some dinosaur technology so they had changed the name of that place.

So that's what disintermediation means and that is very deflationary because you're basically replacing certain things. Now there's also commoditization, so this is. Gerard Cruz: Don't write words you can't pronounce. Gosh I had word 101. Maggie Ralbovsky: Basically means when certain things are new they can demand a high price but once they get copied but when everybody started to copy it and it becomes cheaper to produce mass production then simply you get cheaper. So when you combine these two things a lot of the products people

are using simply do not have the pricing power for price to go up. On the other hand you can see that proportioning CPI which is the measure of inflation has been shifting. Now it has been shifting more and more towards the things that this disintermediation and the C word cannot happen which includes housing. Doris Flores-Brooks: Housing? Gerard Cruz: Housing is a commodity? Maggie Ralbovsky: Housing no can not be replaced. Gerard Cruz: But you had disintermediation? Maggie Ralbovsky: Yes so both of these two pages are trying to highlight the future that may be very different from the past. Dave O'Brien: So buy a house. Maggie Ralbovsky: Can't interpret it that way. So in this context Wilshire has reduced our expectation for equity market return as well as fixed income market return. Gerard Cruz: You've reduced it? Maggie Ralbovsky: We have reduced it because we have achieved a lot of the future return today and now market is trying to consolidate to see if the expectation that's priced into the prices can materialize. So it's going to probably take a break in a trading range market for a while until everything materializes and then decide where to go. So we have reduced our. Doris Flores-Brooks: All of this is down.

Maggie Ralbovsky: All of the expectation is down, yes. 50 basis points across the board for equities and for fixed income on page 13 it's across the board we have reduced fixed income as well. Doris Flores-Brooks: Long term core bonds even reduced more. Maggie Ralbovsky: Yeah. David O'Brien: This is just not a quarter prediction, this is a moving out. Maggie Ralbovsky: That's right a moving out prediction, yes that's 5 to 10 years. David O'Brien: So what does that mean for the optimization? Maggie Ralbovsky: Good question professor. David O'Brien: I should just wait. Gerard Cruz: Or you can continue to show off. We like that too. Maggie Ralbovsky: Wait a little while I'm going to tell you what I need to. So bottom line we are going to rerun the optimization for the future steps. Not yet I'm going to talk about high yield market because we are at a point. Doris Flores-Brooks: What page? Maggie Ralbovsky: Page 15. So the high yield market has experienced tremendous returns tremendous rally since 2008, the return was actually better than equities. If you look at the averages especially if you adjust for risk. Now where do we go from here? We think the reasons for the high yield rally were coming from different places.

Number 1 was because of the Central Banks flooding the market with liquidity and that we expect to continue. We think even the U.S. starts to withdraw liquidity Europe still has to stimulate the economy they're still in a very dangerous zone if they do not provide enough support they can go back to recession. Number 2 reason that can support the high yield market is this thing called great moderation. Great moderation means that. David O'Brien: Gerry's right, you need a new writer. Maggie Ralbovsky: Reduction in volatility across the board because there is pretty much high yield companies are set. They have locked in their borrowing rate, they are steady going forward until something bad happens. So in the near term we think there's a great moderation is actually supporting high yield sector and the third thing is the leveraging being increased in the entire system. So, we talked about the fact that if you were a saver you're basically losing money, you're subsidizing borrowers and that has encouraged risk taking. So, theoretically if you are a logical person you know if I saved I subsidize the next person who borrows, why don't I just change myself into a borrower. So that's what CLO's and all these other things are doing which is to say they borrow money and they lever up to buy high yields. So these CLO's or CDO's they basically lever their structure to buy multiple. So every dollar they have they can buy four dollars worth of high yield. Those are the levered structures that are being created and that CLO and CDO a creation last year has reached the point that's very close to 2007 level so which

has made people really nervous and at the same time really the whole environment is encouraging it.

So bottom line we think high yield has really achieved a lot of return but in the near term probably we're not going to see a crash. We're just going to see steady better trade than Core fixed for sure because core fixed also has a very compressed yield and they do not have a lot of protection against the interest rate movement. David O'Brien: But as you said before that compression is offset by the lower default rates, right? Maggie Ralbovsky: That's right. David O'Brien: I mean you get what you pay for. Maggie Ralbovsky: That's right. That's right. Maggie Ralbovsky: Okay, so these charts I just want to provide some perspective on the different countries in the world are also jumping into the high yield sector. High yield traditionally historically was a U.S. phenomenon. Foreign markets didn't have a very wide, a deep and broad corporate bond market. Foreign bond market tends to be all sovereign in debt. The government who are issuing debt. The corporate sector was a very new phenomenon. Started right now today in Germany and U.K. are the main countries that still have a corporate debt sector but given the fact that these sectors are in such great demand, a lot of people are basically saying hey you know why not so there is a movement of having these different countries having their corporate bond sector opening up and issuing more bond. Even in the emerging markets now China and India are probably going to be admitted to the corporate high yield market in the next few years, they are testing that now.

David O'Brien: What do you mean admitted? Maggie Ralbovsky: They are not in the benchmarks at all because today. David O'Brien: Oh in the benchmark. Maggie Ralbovsky: Yeah because today if you go out to try to buy Chinese corporate bonds you have to be a Chinese person. So they are not like opening up to the world yet but they're testing. Joe T. San Agustin: I understand they are trying to open it up. Maggie Ralbovsky: That's not for the corporate bond sector it's probably for their sovereign very little sovereign bonds for China as well. Sort of a mostly domestic issue. Joe T. San Agustin: Talked to that guy that was here from Hong Kong, there's some. Maggie Ralbovsky: Yeah China always has this envision. Doris Brooks: There's the head of the central bank. David O'Brien: So who is issuing these bonds the Chinese, the Indian high yield bonds? Maggie Ralbovsky: The sovereign. The countries itself, but China and India are not big bond issuers. So the big bond issuers are Brazil, Russia, Argentina, and Kuwait. Those are the big bond issuers.

Okay with that I also wanted to provide this chart because we're at the point of expanding our real estate securities to global securities and I want to show you the reason is because real estate are going through cycles at the different point in different countries so some countries are more expensive than others having this diversification helps us navigate ups and downs of the whole cycle. Okay, questions? No questions I'm moving on. Laboring through it right. Wilfred Leon Guerrero: The market went down quite a bit yesterday and today. Do you have any idea what's going on? Maggie Ralbovsky: I don't know I've been doing Hybrid plan here. Wilfred Leon Guerrero: While you were talking about Hybrid plan the market was going down. Maggie Ralbovsky: I have to get caught up on that. Wilfred Leon Guerrero: You're not prepared to talk about that. Maggie Ralbovsky: No I'm not prepared to talk about that in the last 2 days, I haven't been following for last 2 days. Wilfred Leon Guerrero: It's quite a drop. Doris Flores-Brooks: But usually September is supposed to be a bad month. David O'Brien: Yeah but usually they are rallying now so corporate balance sheets can look good.



Maggie Ralbovsky: Okay, total fund. We actually have August flash so if you want August flash report, Diana has a copy. We did well in August as well. David O'Brien: You can't do the same day flash next day, previous day flash. Maggie Ralbovsky: Well it's all you know money and time. Okay so total fund was up 3.6% for the quarter. Page 20. Total fund did under perform by 39 basis points. Most of our active managers actually under performed for the quarter. Pretty much across the board you can see fixed income. David O'Brien: Oh out performed core fixed income let me think who that is. Maggie Ralbovsky: By 6 basis points. Yeah right your favorite manager. Your favorite little manager. Gerard Cruz: The little guy huh. David again slays Goliath. David O'Brien: Garcia Hamilton oh average. Maggie Ralbovsky: I stand by their rating. Okay, I'm going to move on to page 27, I'm going to look at page 27. Page 27 is a asset allocation calculation comparison between the actual versus the policy and the difference is calculated at the bottom of this page so as it stands today this deviation helped us in the first part of the year, so even though our managers under performed our total fund actually did quite well because of the over weight in equity and last few board meetings we did say that we were going to defer the rebalancing until the new managers are being hired so I have a recommendation later on, on how to rebalance the total fund in the context the new managers are hired. So I'm going to move to page 34, you can take a quick look at historical numbers although we didn't have historical cash flow because the prior consultant couldn't have the information calculated in our data base so we only started tracking March of 2011. Starting from March of 2011 to June of 2014, so that's 3 years, the total investment gain in the Fund was 518 million and that. Gerard Cruz: Since 2011? Maggie Ralbovsky: Since 2011 so the bottom line here the investment gains, 518 million. Gerard Cruz: What did we do last year, just out of curiosity? Maggie Ralbovsky: You see here last year 257 million that's gain. This is gain. Okay. Gerard Cruz: That's market gain, right? Maggie Ralbovsky: Yes market gain. Gerard Cruz: No contributions. Maggie Ralbovsky: That's all neutralized. 257 million. Gerard Cruz: That's a good number. Doris Flores-Brooks: But that's due primarily to the market, the rally. Gerard Cruz: Yeah that's all market. Doris Flores-Brooks: And the fact that you went over was good that you didn't. Maggie Ralbovsky: For this period it was good yes. Joe San Agustin: So this is net after withdrawal. Maggie Ralbovsky: This is net, this is just pure number of gains and you can also see that. Joe San Agustin: We have a lot of withdrawals after that. Maggie Ralbovsky: Withdrawal is 190 million this period, so we're tracking starting from.

Paula Blas: If you look here this is our withdrawals but if we didn't take any this was this would have been. Maggie Ralbovsky: No this is the withdrawal from the fund. Doris Flores-Brooks: 190 is the withdrawals and that's primarily to pay annuities right because annuities now exceed contributions. Gerard Cruz: Annuities, yes. Only like 2 thousand. Paula Blas: The contribution rates start going down. But 190 is for 3 for 13 and part of 14 right. Maggie Ralbovsky: Okay, let's talk about rebalancing. So I have 2 future initiatives I highlighted. Gerard Cruz: Okay go ahead. Sorry. Maggie Ralbovsky: Okay, I highlighted. Doris Flores-Brooks: It should because the nature of the fund is by the time the last guy dies it will be equal, right. David O'Brien: We're just giving him the keys to the account. Doris Brooks: That's right. What page?

Maggie Ralbovsky: Page 36. Page 36, the bottom four yellow highlighted lines are with regard to the new managers to be selected by the Board so once they are selected that's where the recommended funding numbers go to be although I think we probably have to rerun this but

this is the direction we're taking but when we decide depending on when we decide on funding them we're going to probably update. Wilfred Leon Guerrero: Maggie, you need to explain. Maggie Ralbovsky: Okay let me explain. The yellow shaded lines are new managers. I know we have not talked about the index fund for U.S. for non U.S. I will talk about it right now and later on I also want to show you the rationale for that when we review the non U.S. equity composite. So within this recommendation of rebalancing I recommend we add an international equity index fund. Like we did for U.S. equity we have a portion in index fund and I want to also have a portion in index fund for international equity and there's a few reasons I will highlight to you.

In particular, right now the international equity composite has a very strong small cap and emerging market bias, that's number 1. Number 2, it has a very strong bias towards managers that are high tracking era meaning they take very conviction driven kind of approach. The entire portfolio doesn't have an anchor to anchor towards the benchmark, it has pretty wide swings in terms of relative performance and all the managers are under performing since inception all the active managers. That's not to say they're bad managers, it's just to say that if we have all managers in that kind of a high tracking era style, it doesn't smooth the ride. Our ride is pretty volatile because they are all sort of outperformed, under perform in a big fashion.

So the 2 major benefits of having this piece there, number 1 is to anchor the portfolio just like we did for U.S. equity. The benefit is very clear I think at this point. Number 2 reason is to correct the small cap and international bias. The small cap international bias in this composite is very severe, is very strong, I can show you later how strong it is but. Gerard Cruz: Small cap and international? Maggie Ralbovsky: Emerging market bias. David O'Brien: We're talking about International equities okay. Gerard Cruz: So you're proposing. Maggie Ralbovsky: An aquie fund which is the entire market fund. The third benefit is to lower the fees. This fund BlackRock is our index provider. BlackRock index fund is in the A basis joints. Gerard Cruz: How much did we fund them? 66. Maggie Ralbovsky: Yeah, so this works out to be 66. Gerard Cruz: Where does this come from? Domestic or we're just spreading. Maggie Ralbovsky: You see mostly from domestic right so domestic right now is over weighted. Recommended transfers are in million dollars. Right hand side column. So the funding comes from U.S. equity and U.S. REITs. To populate first of all high yield, core bonds, as well as international. David O'Brien: So overall we're reducing our exposure to REITs because we're also going into high yield which you see as another alternative so all we're doing is kind of diversifying our alternatives.

Maggie Ralbovsky: So, REITs has about 2 trillion dollar market cap in the entire world and equity has a total about call it 45 trillion dollars. So REITs as a total market is not 10% and we are currently allocating 10% into the equity into the market. Doris Flores-Brooks: You're taking out all of your REITs, right? David O'Brien: No, no, we're taking out U.S. going global which includes U.S. Doris Flores-Brooks: Oh I see. Maggie Ralbovsky: So a 5% allocation is more proportional because there's 50 trillion. 5% to REITs it's more proportional to the market opportunity set. Doris Flores-Brooks: So you're getting rid of 2 managers and getting a new manager. Maggie Ralbovsky: That's right. Maybe 2 managers I don't know it depends on what the Board decides. Gerard Cruz: What's the allocation? Maggie Ralbovsky: Allocation is about 90 million. Wilfred Leon Guerrero: This is what we talked about. Maggie Ralbovsky: Yes. Wilfred Leon Guerrero: Can you make this thing because

I'm. Maggie Ralbovsky: That's exactly to implement what we talked about. Wilfred Leon Guerrero: Right. right. So... David O'Brien: Not exactly. Wilfred Leon Guerrero: You're using different terminology I think and that's what's worrying me. Yeah it's true we're wiping out REITs that's 10% and we're taking 3% from the equity.

Maggie Ralbovsky: No, core bonds, not equity. Core bonds. Wilfred Leon Guerrero: Okay, 2% so that's 13% that we're messing around with or moving around. Maggie Ralbovsky: No we're 8%. Yeah okay you're in that ok I take your point. Go ahead. Wilfred Leon Guerrero: Okay, so we're putting 8 in high yield and 5 in the global REITs. That's at 13. Okay you're breaking it down further with this 8% the high yield into what you're calling opportunistic core and defensive. Maggie Ralbovsky: Yes. Correct. Wilfred Leon Guerrero: Okay. I just want to make sure I'm following. Can you explain to me what are these 3 categories on the high yield because all the time you've been talking about high yield bonds and.

Maggie Ralbovsky: Okay let's do that. So if you look at the benchmark. Doris Flores-Brooks: I always thought as one category, but there are 3 sub categories. Maggie Ralbovsky: Let's start with the benchmark of high yield. Okay, High yield benchmark you think about as Dr. LG you have mentioned earlier very correctly that currently we participate in the risky high yield companies stocks but not bonds. But bonds are not a single category. You think of a companies capital structure starts with loans. Starts with bank loans and then goes to secured debt goes to subordinated debt. Goes to really I guess convertible debt and all the way to equity. So goes from high to low. A company can have many, many different tranches in this capital structure. Okay, so currently we're in the bottom tranche. High yield covers the entire tranche above the equity. But if you look at the high yield benchmark high yield index it only covers the middle portion. High yield index says that it cannot be alone, it cannot be below certain rating, it cannot be converts, it cannot be preferred, it cannot be these other things. It can only be the bread and butter in the middle and that's a core manager. A core manager plays in that sandbox. An opportunistic manager says okay if I want exposure to this company if I think the loans are actually cheaper than the bonds, I should do that. If I think the converts are better than this sandbox, I should do that. So the opportunistic shift in across the different part of the capital structure. Well that's an opportunistic manager.

Now, defensive manager is a core manager it's just playing in the core sandbox but they are defensive in different ways like we had seen Hodgkis only buys small and mid cap company. Wilfred Leon Guerrero: You know I think we're familiar with bond ratings so like what would be. Maggie Ralbovsky: Would be the conservative manager the defensive manager will say you know I'm playing the middle sandbox but I really don't want triple C rating company well I do very few triple C. Let's remember this sandbox in the benchmark has up to 20% triple C. So their managers will simply buy no triple C. There are managers who simply will not buy more than 15% triple C and those are defensive managers because when the market rallies these are managers that were lagged they lagged because triple C rallied first. So that's why in the high yield category it is not homogenous not a manager you know that just does you know a homogenous many, many different categories of high yield managers. So we were talking about the allocation I had suggested we need to have a core manager and we need to have an opportunistic manager.

Wilfred Leon Guerrero: Core manager buys triple C. Maggie Ralbovsky: Triple C. Core manager triple C usually goes to where the benchmark is. No, core manager is not just defined by triple C but defined by this middle sandbox as I said. That's right what's in the benchmark. Not going up and down the capital structure widely so that's the core manager. I do believe we need to have at least a core manager and A opportunistic manager. Now when we received our RFP response, we gotten many good managers and they are in very different categories so I'm now suggesting we have 3 managers. In the core category divided up with a core-core and defensive core. Doris Flores-Brooks: And then the opportunistic. Maggie Ralbovsky: The opportunistic is the opportunistic. David O'Brien: We're ready to decide. Maggie Ralbovsky: You already decided? Okay. Doris Brooks: No but let me ask you this Maggie, you could just have higher yield and only the core. Paula Blas: She's only doing the asset allocation first. Maggie Ralbovsky: If you just have one high yield manager you would be in core. Doris Flores-Brooks: But you could go that way too, but you're suggesting to further. Maggie Ralbovsky: We have so many good responses. About 27 responses. Paula Blas: So are you ready to decide that's the 3 managers? You want to do the 3.

Wilfred Leon Guerrero: I just want an explanation and I want to make sure that we understand. Gerard Cruz: Do these managers, are they subset, is it part of their DNA or do they shift? Maggie Ralbovsky: Well the opportunistic manager shifts. Gerard Cruz: No I understand that. But if they are an opportunistic manager today, next week they are not going to become core? Maggie Ralbovsky: They are always opportunistic. No, no these managers are very decided in one category. Gerard Cruz: Yeah but it's like everybody else I've never heard of the different subsets but then I don't know if it's just by chance or something. David O'Brien: When we interviewed them you could really see their biases and their approach. You know I tell you that 7 had as much as they're all in high yield. Maggie Ralbovsky: They're very different. Gerard Cruz: Different? Okay. David O'Brien: They're very different. Gerard Cruz: No I think that's a good idea actually since. Maggie Ralbovsky: Okay, with regards to global REITs, it is actually a more homogenous category but the allocation is pretty large, so you can support a more than one manager especially prospectively speaking if you think the asset size is going to go bigger and also you may split it depends on what the Board decides. Also for global REIT managers, minimum tend to be low because of equity. They will run the 5 million, 10 million separate accounts. High yield however you need an asset base to run a separate account.

Gerard Cruz: 10 million? Maggie Ralbovsky: Yeah for global REITs 10 million is a pretty large account you know to run separate account. Gerard Cruz: Is it? Maggie Ralbovsky: Yeah because it's stocks. They only have to buy 30, 40 stocks. Not like high yield you have to buy probably 200 issues you know to diversify. Gerard Cruz: Okay, so 2 or 5? Maggie Ralbovsky: 2 is fine. Gerard Cruz: Because that's a big mandate right considering that. David O'Brien: How were the REIT managers that was your group, right? Gerard Cruz: Actually they were good, two are incumbent managers. David O'Brien: They are also in U.S. you mean? Or just located in different part. Gerard Cruz: Well incumbents on different mandate. One was DFA for small cap, the other one was. Wilfred Leon Guerrero: Maggie we're going to recommend 3 high yield and 2 global REITs. Maggie Ralbovsky: So for the two global REITs you do not necessarily have to split in the middle, you do not necessarily need to do that. Paula Blas: No, you can go 60-40. Maggie Ralbovsky: You can decide on what is the best way to do it. Depends on which 2 managers you selected. David O'Brien: We can

do that in high yield too, right? Maggie Ralbovsky: Well for high yield you have to constraint to 50 million dollar minimum because if you don't have 50 million dollars you pretty much can't run a very efficient diversification. Gerard Cruz: Oh 50 million is the minimum on high yield? Maggie Ralbovsky: On high yield. David O'Brien: You got 44. Maggie Ralbovsky: That's right. If you give them 45 its fine but if you give them 30 it's probably not fine. You know what I mean? David O'Brien: Oh I see what you're saying. But the core bond not so high, right? Maggie Ralbovsky: No, core bonds not high. You need two bonds in the core category to replicate index. Gerard Cruz: And two managers? Maggie Ralbovsky: No, theoretically to replicate the indexes duration and complexity and credit quality you only need two bonds. Not like in high yield you need probably 150 issues. Gerard Cruz: I see. So the yellow, the highlighted area, I'm sorry Dr. LG.

Wilfred Leon Guerrero: So if we do decide to go for two managers and then go global REITs, we're going to have to increase this 83 million to 100, right because they're saying. Maggie Ralbovsky: No, no I'm talking about the high yield 50 million dollar minimum. Global REITs you can give them 10 million, 20 million. Wilfred Leon Guerrero: I thought you just said there's a minimum, oh the high yield. David O'Brien: We just have to make more money Mr. Vice Chairman. Maggie Ralbovsky: DFA may even take a few million because theirs is a fund, right. Gerard Cruz: How do you know DFA is going to win? Maggie Ralbovsky: Oh I didn't say they were going to win. I didn't know which. Gerard Cruz: So you're saying you want them. Maggie Ralbovsky: I'm just saying. Gerard Cruz: They'll take a smaller allocation. It was just one who needed a 10 million that was their minimum allocation, it was CRE. Maggie Ralbovsky: CBRE. Gerard Cruz: CBRE. Maggie Ralbovsky: I think the other one also needed 10, right. Cornerstone. Gerard Cruz: Cornerstone is running 67 million. Wilfred Leon Guerrero: Gerry, do you have any problem with hiring 5? Gerard Cruz: No.

Maggie Ralbovsky: We're not talking about managers right now guys. Gerard Cruz: No we're not talking managers we're just talking allocations. Joe San Agustin: Don't spread ourselves too thin. Gerard Cruz: No, no we're not going to spread too thin. But you know I think 2 managers under the global REITs mandate is a wise idea because that is a pretty sizable allocation. Joe San Agustin: And that's where the concentration? Gerard Cruz: It will be concentrated if we only have one manager, right? Because right now we're running. David O'Brien: We found 2 good ones. Gerard Cruz: We found 2 respectable ones, yeah 2 really good ones actually. Maggie Ralbovsky: Okay, lets. Wilfred Leon Guerrero: So where are we going to get for the high yield bond? You need 150. Gerard Cruz: This is the minuses. Maggie Ralbovsky: If somebody says they want 50 million dollars, then we give them 45, its fine. Wilfred Leon Guerrero: Okay. Maggie Ralbovsky: It's fine with 45, then it'll grow to 50. Wilfred Leon Guerrero: Oh, okay. Maggie Ralbovsky: Just bending the rules a little bit. Okay, so that's my first recommendation. The second recommendation is that we're going to move on to our step 2 policy but I'd like to reflect our new capital markets expectation. I'd like to rerun the optimization to determine a second step for the rebalancing. And I would like to probably during the next meeting introduce these two categories which I think will be beneficial. Gerard Cruz: Which ones? Maggie Ralbovsky: Risk parity. Gerard Cruz: Oh risk parity. Maggie Ralbovsky: Risk parity. Gerard Cruz: Here we go. Maggie Ralbovsky: We're going to talk about buckets again guys. And second category would be liquid alternatives.

Wilfred Leon Guerrero: At least the terminology is not big terminology. Gerard Cruz: I know. Maggie Ralbovsky: So that's the next time we're going to discuss those. David O'Brien: You know Gerry I think the risk parity that's been a subject at our conference. Gerard Cruz: It is, it is the topic. Doris Flores-Brooks: What is risk parity? Gerard Cruz: Oh. Paula Blas: Okay, get her started. Maggie Ralbovsky: It's a risk factor based allocation rather than the asset allocation. So you just called different assets different names doesn't mean they are not influenced by the same risk factors in the economy. So if you tease all the different risk factors out you group them together instead you get a more balanced portfolio with regard to. David O'Brien: Is this like matching correlations or something? Gerard Cruz: More like mismatching it. So it's like building a portfolio based on risk rather than building a portfolio based on return but using leverage as a basis to match the risk of fixed income to the risk of equity. Maggie Ralbovsky: Exactly. Exactly. Gerard Cruz: That's a scary part because leverage works or leverage makes everything greater in my opinion. David O'Brien: Up and down. Gerard Cruz: Up and down. It's indifferent. Maggie Ralbovsky: That is true. Okay, so these are the 2 categories I think our prime candidate for step number 2 so we're going to discuss those. Gerard Cruz: So next time? Maggie Ralbovsky: Next time, November. Gerard Cruz: November what? So I'll make sure I'm not here. Maggie Ralbovsky: 20, 21 the week after your conference. Gerard Cruz: So come to the conference and we'll blow up risk parity during the conference and we'll. Maggie Ralbovsky: I wasn't invited to this conference. Gerard Cruz: You don't need an invitation.

Gerard Cruz: We didn't invite. It's open, anybody can come. Maggie Ralbovsky: But it's the money managers that pay into the conference to show up, right? Gerard Cruz: Money managers do, we have all kinds of different sponsors not just money managers. Maggie Ralbovsky: Are there sponsors who don't pay? Gerard Cruz: Are there sponsors. We have speakers that don't pay. Yes we have speakers that don't pay. Doris Flores-Brooks: How many people usually come? Gerard Cruz: About 200-300. Maggie Ralbovsky: The reason we actually have a policy that says is that we don't want to be influenced by money managers you know what I mean. David O'Brien: Why should you be influenced at all? Gerard Cruz: Yeah why should you be influenced at all? Maggie Ralbovsky: Because if money managers pay for your conference meal you sort of make a mental note. Gerard Cruz: No, that's not true. They're not paying for conference meal. There's an entry, we charge the attendee an entry fee. Paula Blas: There's a registration. David O'Brien: It's like your typical gold, bronze. Maggie Ralbovsky: But don't you have to put a whole thing together, today's meal is sponsored by BlackRock. David O'Brien: No we don't do that. Maggie Ralbovsky: There's transportation it's sponsored by Merrill Lynch. David O'Brien: We don't do that. We have vanilla, gold, silver, bronze sponsors.

Maggie Ralbovsky: I'm going to be in Pohnpei. Gerard Cruz: Of course you're in Pohnpei. But nobody is going to be in Pohnpei. Everybody in Pohnpei is going to be in Manila. Maggie Ralbovsky: No, actually I don't think so. David O'Brien: Yeah actually they are all at the conference. Maggie Ralbovsky: The President? No I'm supposed to meet with the President. Gerard Cruz: Of Pohnpei? Maggie Ralbovsky: Of FSM. What day is your conference? David O'Brien: 13-14. If that's a Thursday, Friday those are the days. Maggie Ralbovsky: I definitely can not do it. I can not do it. Okay, I'm going to speed it up. I'm actually going to mention one thing for U.S. equity. Gerard Cruz: Okay go ahead. Maggie Ralbovsky: The one thing for U. S. Equity I continue to recommend to put Eaton Vance on watch not only they're performance disappoints but also they recently went through a reorganization of their

research platform so now they have dismantled all their centralized teams, they have allocated all the different sectors have their own dedicated research effort and in the mix of this actually there was one financial sector analyst who used to work on this strategy for Nancy and she quit. And I don't know if it's the beginning of.

Gerard Cruz: Nancy is still there? Maggie Ralbovsky: Nancy is still there. Nancy is still there but her team has lost a couple of people in the past 2 years and their performance also has been pretty spotty. So I continue to. Wilfred Leon Guerrero: I've never met her. Gerard Cruz: You did meet her. She's the reason why you hired her. I'm just kidding. Maggie Ralbovsky: So, Eaton Vance continue to recommend them on watch. Number 2, development in Numeric was purchased by ManGroup. Gerard Cruz: But just for distribution though, they're not going to be involved in the investment process. Maggie Ralbovsky: Yeah and we view this very neutral and this is not something that surprised us. Just want to update now Numeric is now owned by ManGroup because their previous private equity owner actually sold their shares. So this is a neutral development in our view and also at some point in the past we talked about the out source holding and that they have divested all that holding so there's no more issues there.

So now let's take a look at International because I want to talk about that bias. If you look at page 52, the gold football, the gold circle is the combination of all our managers in the International composite. Compare that with the line that's called the MSCI AC World Ex USA IMI Index. An IMI index is a total market index for International which includes small cap. So this covers 99.9% of all public trading securities in the International market and that is how large it is compared to our composite and our composite is significantly smaller than the total market. Now that introduces a bias when small cap does well we do well, when small cap does not do well, we do not do well. The structural balance in the long run does not get paid and also part of this bias was due to emerging market over weight. Emerging market in the entire world is about 15% and our allocation is a lot higher than that. Also, the observation that our active managers, I have a chart on their performance on page 50. Our EAFE managers Earnest and Fisher. Earnest is the blue football, Fisher is the red cross this is the universe comparison of our managers. Earnest has historically been a good manager but most recently you can see the performance has deteriorated. That's not to say they are not a good manager, their style is entirely out of favor and this is the style risk we're running with the concentrated manager. Earnest is quite concentrated they hold like 40 stocks in a universe that has thousands of stocks. And Fisher you can see Fisher performance historically has been very spotty.

Gerard Cruz: Fisher is a domestic, I mean macro. Maggie Ralbovsky: Macro. They are macro driven managers. If they're right, they're right, if they're not right, they're not right they are sort of not very consistent. That brings me to the recommendation of having an anchor for this portfolio which is an index fund that doesn't really bet against the trend. Gerard Cruz: So you want to move money out of these managers and move it into the index fund? How much? Maggie Ralbovsky: How much is in the. David O'Brien: She has it on that other page we were on. Remember it when she was the same as the high yield page. Gerard Cruz: Okay. Maggie Ralbovsky: We can go there and if you look at Cap Guardian. Cap Guardian has been a manager that has. Wilfred Leon Guerrero: What page are we on? Maggie Ralbovsky: Page 51. Wilfred Leon Guerrero: And just for your information Rosie is taking notes. Maggie Ralbovsky: Page 36. Cap Guardian performance has being

deteriorating and Cap Guardian also is in a category that we're over weighting. So, I would like to recommend the index fund to be an Acqui index fund meaning it covers emerging market. Another good benefit to that is the fact that the index provider is considering changing the index composition. They're discussing taking Taiwan and Korea out of emerging market and put that into EAFE and they already had taken out Greece from EAFE and put it into emerging market and they are also considering putting Nigeria back into emerging markets.

So there's many, many different initiatives being discussed on changing the benchmark so when we want an index fund, we want an index fund that doesn't get impacted by the definition of somebody. So the most probable index fund is the Acqui X U.S. index fund that includes all the countries. It doesn't matter what you say which one is emerging market. Gerard Cruz: Except U.S. Maggie Ralbovsky: Yeah, Acqui X U.S. Gerard Cruz: So that's what you're recommending we move? Maggie Ralbovsky: Page 36, I'm recommending taking 17 million out of DFA, 16 million out of Capital International. Wilfred Leon Guerrero: Do you have that in writing someplace? Maggie Ralbovsky: It is page 36. Wilfred Leon Guerrero: Yeah but. Gerard Cruz: But in a motion format. Joe San Agustin: But that's going to have to go through the Board. Maggie Ralbovsky: We can write a motion format. Gerard Cruz: Or unless you are going to refer this. David O'Brien: 17 go to the last column vice chairman. Maggie Ralbovsky: The recommended transfer column. Doris Flores-Brooks: The reds are the transfers out and the blacks are transfers in. Maggie Ralbovsky: Dr. LG. don't look at that column just look at the last column. Gerard Cruz: Okay, so this is all your recommendations? Maggie Ralbovsky: This is all my recommendation. It's all in this one page. Gerard Cruz: Thanks.

Paula Blas: Almost done? Maggie Ralbovsky: It's done. We're done. Gerard Cruz: We're done okay. Paula Blas: Wait, did you make a motion? Wilfred Leon Guerrero: No, we're not done. Say that slowly again. Where are you going to put the 17 million. Maggie Ralbovsky: All the dark numbers. Rosalia Bordallo: You can't look at it as I take 17 and 16 and move it to a spot. The recommendation is to look at the whole sheet and all these liquidations will be applied. Wilfred Leon Guerrero: Do you understand it? Rosalia Bordallo: Yes. Wilfred Leon Guerrero: Okay. Rosalia Bordallo: It's not a specific where I liquidate and I say I give it to you. Maggie Ralbovsky: Guys one more thing, not adjourned yet. So this whole rebalancing needs to be handled by a transition manager because we're doing multiple categories of transitions. David O'Brien: We did that. Joe San Agustin: What do you hope to gain? Maggie Ralbovsky: No, I'm saying we need to appoint a transition manager to handle this rebalancing so this is not to be done by somebody your marking is to that. Doris Flores-Brooks: Well didn't you have a transition manager before? David O'Brien: No we're hiring one. Paula Blas: We are in the process of hiring. Doris Flores-Brooks: I thought you had already because I remember you saying it earlier. Rosalia Bordallo: That's not a permanent one. We had one temporary for last time. Joe San Agustin: You're hiring a transition manager for the sake of hiring a transition manager? Maggie Ralbovsky: No, this rebalancing is a multi sector rebalancing, we need a transition manager to handle it.

Joe San Agustin: I know but the rebalancing is that a neutral position. Neutral position. What are you getting out of it? What's your objective? Maggie Ralbovsky: My objective is to rebalance the portfolio to target because it's multi category. Joe San Agustin: That's what I'm saying what is the strategy. Maggie Ralbovsky: Page 36 is the strategy and we're going to





have a transition manager. Joe San Agustin: What is the expectation on that? Gerard Cruz: Expected return. Maggie Ralbovsky: Expected return on that? Joe San Agustin: Yeah what is it. What is it for? David O'Brien: It's that book here. This is the complete strategy. Joe San Agustin: That's step 1, 2 but then I'm looking at the end of the rainbow. For what? Gerard Cruz: I think the expected return was 7 something. Wilfred Leon Guerrero: The explanation has been going too fast that's what my problem is too. Maggie Ralbovsky: Well can I fix that? Which part do you want me to repeat? Wilfred Leon Guerrero: I'm sorry. Maggie Ralbovsky: Did you say I said it too fast? David O'Brien: The strategy he's saying the strategy. Wilfred Leon Guerrero: No, no in fact I finally caught up but I've been looking at this for 2 days trying to figure out what the heck is going on. And it's something that we approved but now we are in the implementation stage.

Gerard Cruz: Yeah right here, 36. Paula Blas: But is the expected rate of returns in that book? Gerard Cruz: Yes. Maggie Ralbovsky: The goal is to increase return and reduce risk. Joe San Agustin: What is your expected return? Maggie Ralbovsky: Chair I don't have the numbers ahead of me but I think it increased to something like 20. We're going to increase return expected return. Joe San Agustin: You have no expectation? Maggie Ralbovsky: I have expectation. Joe San Agustin: What is your goal? 2% high. Maggie Ralbovsky: It's not 2%, probably 20 basis points. Joe San Agustin: Concentrating on a high which is basically to me somewhat. Maggie Ralbovsky: You could, yeah. David O'Brien: I just read my favorite valuation on Garcia Hamilton.

**Respectfully submitted,**

**Affirmed:**

  
  
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**Angelina Castro / Marilyn Aguon**  
**Recording Secretary**

  
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