INVESTMENT ADVISORY COMMITTEE

The Investment Advisory Committee held its quarterly meeting on Wednesday, June 1, 2011, at the Bureau of Investments, Great Lakes Conference Room, 2501 Coolidge Road, Suite 400, East Lansing, Michigan.

Members Present:

David G. Sowerby, Chairman
Roger D. Robinson
Steven H. Hilfinger, LARA
Phillip J. Stoddard, DTMB

In attendance from the Department of Treasury: Andy Dillon, Jon M. Braeutigam, Robert L. Brackenbury, Gregory J. Parker, Karen Stout, Brian Liikala, Richard Holcomb, Peter Woodford, Paul Nelson, Jack Behar, Jim Elkins, Kevin Fedewa, Giles Feldpausch, Amanda Ellis, Marge McPhee, and Emma Khavari.

Others in attendance: James Voytko, Allan R. Pohl, Gus Sauter, James Caine, Anthony DeCesaris, Chris Michalakis, Molly Jason, Jason Diotte, Renaye Manley, June Morse, Frank Cody, Joe Curtin, and Cara Spagnuolo.

Call to Order and Opening Remarks

Chairman David G. Sowerby called the June 1, 2011, meeting to order at 9:30 a.m. noting that the performance for the quarter improved, with more work to do on a relative basis to the peer group. Chairman Sowerby noted he had reviewed a large public fund universe plan larger than a billion, with a sample size of 64 and the SMRS return of 4.9% for the first quarter put the portfolio in the top decile. He noted this should be happening since the exposure to private equity lags in up markets when public markets rally first. He then turned the meeting over to the State Treasurer, Andy Dillon.

Treasurer Dillon introduced and welcomed Mr. Steven H. Hilfinger, Director of the Department of Licensing and Regulatory Affairs. Chairman Sowerby also welcomed Director Hilfinger.

Approval of Minutes of March 3, 2011

Chairman Sowerby asked for a motion to approve the March 3, 2011, minutes. A motion was made by Mr. Phillip J. Stoddard and seconded by Mr. Roger D. Robinson to accept the minutes as read. The motion passed unanimously.

Approval of Code of Ethics and Standards of Conduct

Chairman Sowerby asked for approval of the Code of Ethics and Standards of Conduct with respect to the Investment Advisory Committee. He explained that this is a significant initiative and very consistent with the Governor's speech earlier this year for strong ethics within state government and the mission, as an advisory board, with the focus on the participants of the plan.

There was a short discussion about the Code of Ethics and Standards of Conduct. Mr. Robert L. Brackenbury explained that the focus of the Code of Ethics and Standards of Conduct is in line with what is actually done and what individuals are responsible for during the time they serve on the board. Mr. Brackenbury further explained that this is in line with other public pension system models. Other states that were reviewed were Virginia, Pennsylvania, Illinois, Indiana, and Ohio, which have a specific state statue that is directly applicable to their pension system or have their own board adopted ethics policy. Bureau of Investment employees are already covered by the State Ethics Act and a Bureau of Investments Ethics Policy.

Chairman Sowerby again asked for approval of the Code of Ethics and Standards of Conduct. A motion was made by Mr. Phillip J. Stoddard and seconded by Mr. Roger D. Robinson to accept the Code of Ethics and Standards of Conduct. The motion passed unanimously.

Performance

Mr. Jon M. Braeutigam reported on the performance of the SMRS' portfolio for the time period ending March 31, 2011. He summarized the returns for the fund and the different asset classes noting that the quarterly return for fund the period ending March 31, 2011, was 4.9%. He noted that private equity had a great quarter and that they lag the stock market. Real estate also had a great quarter and year and they lag the public markets as well. He noted that the one-year return was 14.2%, this is a great return on the fund given the diversification of the portfolio which includes bonds. The returns on an absolute and a relative basis; for the one, five, and seven year are either at or above the peers.

Mr. Braeutigam stated that domestic equities, which is 35% of the total SMRS' portfolio, underperformed in the one-year time period, but was above the index in the three and five years. The small-cap managers have done very well versus their benchmark while the large and mid cap managers had a more difficult year. He noted there has been improvement in international equities. The dollar hedge is down to about 20% and is hedged to the Euro, the pound, and the Yen, but mostly to the Euro. He discussed the Euro, from an economic model, that it is a bit over-valued right now on a purchasing power parity basis. Over the past three years, international has been average or better and the underperformance has narrowed in other time periods. International equities had a great quarter. He looked at alternatives and real estate noting for every single time period they are either at or above their individual benchmarks or peers. Diversification has really helped the portfolio on a long, medium, and short-term basis.

Mr. Braeutigam discussed the bond portfolio. Over the past year or two the spreads have really come down. Only 14.5% of the portfolio is in bonds, most of which are safe and high-quality bonds. He pointed out that the returns are all good in the seven, five, and three year timeframes. He discussed the commodities, a small component of the fund, which are highly volatile; they can really shoot up, then go sideways, and then go down. He noted that opportunistic investment, which is a host of different investments, returned 12.7%. This is a relatively small percentage of the portfolio.

Mr. Braeutigam concluded his presentation discussing the standard deviation of the portfolio. He noted that standard deviation is a way to measure the risk taken in the portfolio and returns come at a cost, called risk. He pointed out that the standard deviation for the SMRS' portfolio is lower compared to the returns of peers which is due in part to the larger allocation to real estate, alternative investments, and absolute and return. Risk cannot be eliminated from the portfolio, but it can be managed to a degree.

Asset Allocation

Mr. Braeutigam reported on the SMRS' asset allocation. The SMRS for the time period ending March 31, 2011, had a market value of $51.365 billion and at the beginning of the year the fund was at $49.723 billion. There was $713 million in net benefit payments made during the first quarter. This payment is in excess of employer and employee contributions. He discussed how the cash is deployed and cash has to be raised every quarter to meet the obligations to pay benefits. This cash was raised through the sale of domestic equities and fixed income. He discussed the increases in investments in international equities and absolute and real return to have these areas reach their respective asset allocation targets.

Mr. Braeutigam talked about the approved asset allocations in the Investment Policy Statement. This statement is the governing document that the State Treasurer signs once every two years and it shows the different asset classes and the asset allocation for each class. He discussed where each asset class is at the end of the first quarter and the target to be reached over the next year. He noted that in real estate pricing has shot up of late. He talked about the alternative investments portfolio which has an allocation of 20.7% and to lower this allocation to 14% will take some time as the portfolio for alternative investments is a mature portfolio.

Mr. Braeutigam briefly discussed the Asset Liability Study done by general consultant, R.V. Kuhns, which showed that the liquidity of the SMRS' portfolio is adequate. He discussed the absolute and real return and building the portfolio to the asset allocation target. He concluded noting that investing cannot be done in a vacuum, the liabilities and goals must be clearly understood and taken into account.

Capital Markets Overview

Mr. Greg Parker began his discussion of the capital markets noting that the annualized rate of return for the past two years was 19%. In looking at the outlook, it is not likely these rates of return will happen again in the next two years. However, the rates of return will be decent. He explained the two key elements that provide this conclusion: one is the economic backdrop and the second is the capital markets backdrop. He discussed a few of the factors that influence these two backdrops. He noted that two years ago things went from crisis to stability, then the dawning of stability to growth, and today to post-recovery into a more normal state. Economic indicators suggest the rate of growth is going to be tepid, but it is still growth.

Mr. Parker indicated that the capital markets backdrop is shown on the Efficient Frontier charts. The first chart shows the historic returns, the volatility of those returns, and a good guess for long-term rates-of-returns going forward. The more risky the asset classes the higher the expected rates-of-return; to get a little more return there must be a lot more risk. The bottom chart takes the strategic asset allocation assumptions and tweaks them for current capital markets. He noted that the SMRS' portfolio is 70% to 80% committed to equities; the Fed's zero interest rate policy is very accommodative, which makes the risk/return that investors have to make more attractive and they take on more risk; the distance between the cash (the least risky) and U.S. fixed income is where the Fed targeted their QE-2 policy; and because of strong returns there is a momentum into the capital markets which helps good returns to keep going. He concluded his presentation noting that decent rates-of-return are expected for the next one to two years.

Economic and Market Review and Outlook

Chairman Sowerby stated in the spirit of time the Economic and Market Review and Outlook will be received and filed.

Chairman Sowerby introduced Mr. James Voytko from R.V. Kuhns.

Asset Allocation Liability Study – R.V. Kuhns – Mr. James Voytko

Mr. Voytko began his presentation noting he would be moving quickly through the Asset Allocation Liability Study. He would be going from 30,000 feet, to 10,000 feet, and then do a fly-over at 1,000 feet, but never touch the ground. The Study is approached with some trepidation. These studies are the hottest product going in public fund-land as well as in corporate plans. People try to triangulate their investment strategies against their actual liabilities. He explained the reason for the trepidation as being there were two significant negatives that were going to be present in the Study – the first was a major change downward from the last study in assets; and the second was a rapid maturation of the plan demographically because of the early retirement program that the State put in place. This moves up the ratio of inactive, i.e., benefit-drawing members as a percent versus those that are contributing. These factors have tended to create, in past asset liability studies, some serious problems for defined benefit plans. The changes in the contribution policy, in particular the retention of the actuarially required contribution policy, and the restructuring of the Defined Benefit (DB) plan resulted in a reduced normal cost because of reduced benefits as some of the weight of retirement savings moved to the Defined Contribution (DC) side; these changes were a major plus.

Mr. Voytko explained that everyone forgets how slowly DB plans move, which is like a glacier. Patience and long-term thinking are mandatory, not optional. Any changes or even closing a DB plan entirely has to be looked at through the paradigm of multiple years and in some cases multiple decades. He discussed the financial health of the Plan over the next 20 years given the recent changes. The Study showed the possibility for improvement over the next 20 years, this does not mean that it will improve every single two or three year period. But directionally the state is set for a fairly material improvement in the DB plan. He explained how the Plan started out in a deep financial hole – 59% market value funded and a large unfunded actuarial liability; the cost of the recent early retirement program, and the dominance of the higher cost old Plan members versus those in the new Plan for several more decades all create major financial challenges.

Mr. Voytko noted that the changes to the Plan coupled with its ARC (actuarially required contribution) policy appear to place the Plan on a notably more conservative path for pension funding. He discussed three of the changes: the rapid five-year contribution program to pay for the early retirement program; retention of the ARC-based contribution policy; and a lower assumed rate, which maintains pension contributions at a higher rate. All these set a more financially conservative course for pension funding and long-term pension health. He noted that they have been several studies versus other public plans, this is one of the most clear movements toward more conservative funding of a public DB plan that they have seen. He stressed the adherence to the ARC-based contribution policy, as painful as that can be on the budgeting side, there is a gap opening up in public fund-land between those that are paying the actuarial required contribution and those that are not. This gap you can drive a truck through it now and if it persists for another few years, it will be wide enough to drive a locomotive through. He explained when an asset liability study was done, it was the investment strategy that made the difference from one scenario to another; however, now it is the contribution policy and less so the investment policy.

Mr. Voytko discussed the more conservative financial posture and continued reliance on the ARC-based contribution allows the investment side to continue to take the risk necessary to earn the returns that are needed to take the Plan to a fully-funded status. In this case the contribution policy is supporting and allowing the investment policy to do its work. He explained what happens when more risk is pursued. If risk is increased too much what happens is too much reliance on more complex and volatile strategies. These two have negative affects. One negative affect is that the complexity of the portfolio becomes challenging to staff and even the outside managers; and the second is the chance for a one-year draw-down would be shocking to the system. The fact that more risk can be taken does not necessarily mean that should be done. He stated that from academic-land as well as in corporate-land, there is a move toward ultra-conservative pension funding. This is typically coupled with massive increases in contribution. He stated they love to preach risk control, but they see no payoff to pursuing an ultra-conservative strategy. This would lock the Plan in permanently to the under-funding that currently exists and not allow the new conservative posture now taken to free the investment side and continue to try to earn returns. He stated ultra-conservative is not recommended.

He stated it is time to descend to about 1,000 feet, to discuss the two kinds of analysis that was done in the Study – deterministic analysis (Goldilocks Forecasting) and stochastic analysis (Real World Forecasting). He began with the deterministic analysis, which he called Goldilocks Forecasting. This is linear, every assumption that is made in the plan occurs every year without fail, exactly as assumed for 20 years in a row. This seems very unrealistic. He explained the reasoning for thinking this way: these are assumptions; it does allow for looking directionally; and it allows for the change of one of the assumptions to look at its affect on everything else, assuming that they all stay the same, which is much more difficult to do when introducing uncertainty into the analysis.

Mr. Voytko began discussing the six points that were drawn from the deterministic analysis:

First: the Plan begins in a deep financial hole, a $25 billion short fall – 59% funded. He added that this Study is as of September 30, 2010, this is the date of the actuarial data that was available for the Study. The Plan is in a better position at the present time.

Second: the plan demographics were significantly accelerated by the early retirement program. The actuarial data shows that in six years there will be more in-active members than active contributing members.

Third: the pay down has been accelerated for the early retirement program; with adherence to the ARC policy, this ameliorates the pressure substantially. In fact, the payout ratios are extremely low as forecast in the Study with the possibility that this may improve over the next 20 years. When the payout ratios are high, in the 20% to 25% range, it makes it difficult to invest in private equity, real estate, and other illiquid assets.

Fourth: under the deterministic analysis, the direction is clearly positive. Over the 20-year study period, if all the assumptions are met each and every year, the funding ratio is expected to improve about 20 percentage points to 81%. A change from 59% to 81% is a very material change and it is a reflection of the more conservative path on which the Plan has now been put.

Fifth: many constituents, who do not know how tough it is to both administer a DB Plan as well as to invest for one, think that if there were higher returns, they would be able to invest their way out of it. When the arithmetic is done, it takes extremely high returns to actually make that happen. In the deterministic analysis to achieve full funding in 10 years, the returns earned would have to be 12.7% on the portfolio every single year without fail. This would mean no down year, no year below 12.7%. This is not realistic.

Sixth: under the deterministic analysis, the question must be asked: how sensitive is this to actually earning the assumed rate, which is 8%, adjusted downward 1/10 of a point, by 1/10 of a point as new members are worked into the system. A persistent shortfall in the investment returns reduces the expected rate of improvement in the health of the Plan; however, a modest shortfall, 50 basis points annually, should not be catastrophic. The funding ratio would still improve, just not as much and the payout ratio would degrade a little. So, a more conservative contribution policy has given some degrees of freedom in terms of error if the capital markets are not kind over the next 20 years.

Mr. Voytko began discussing the four points that were drawn from the stochastic analysis:

First: the funding ratios for the Plan show improvement under all diversified investment strategies that take sufficient risk to pursue the level of returns needed to meet actuarial demands. When tremendous amounts of investment uncertainty are introduced, the funding ratios still show expected improvement under a variety of diversified investment strategies. They take enough risk to have the prospect of earning the level of returns needed to meet actuarial demands. There is a caveat, it must be remembered that uncertainty cuts both ways, so there is also a probability that when uncertainty is introduced into investments there could be little or no improvement maybe even being worse off than before.

Second: there is no projected improvement in the financial health of the Plan in pursuing ultra-conservative investment strategies. Being ultra-conservative means allocations like 80% bonds, with very low returns, very low volatility and the probability of being no better off than today is about 58%.

Third: investment strategies with risk profiles more aggressive than the current portfolio appear to offer the prospect of additional financial improvement with roughly the equivalent downside.

Fourth: the potential attractiveness of taking more risk disappears when the additional risk above the current target portfolio type of asset allocations is considered. The allure of increased risk disappears when the full consequences are analyzed: the requirement that they are pursued persistently with no variation over the next 20 years; the short-run, one to five years, consequences versus more risk-controlled diversified strategies are worse; that the significantly higher risk strategies will likely create notably larger one-year maximum declines in fund value during the 20-year path; and that significantly higher risk strategies will almost certainly require more reliance on more exotic and/or complex investments in emerging markets, hedge funds, and private equity.

Mr. Voytko summarized his presentation noting the implications for asset allocation and the investment program strategy. In the many plans that they have researched, the more conservative posture of the Plan is relieving the pressure on the investment assets to take higher levels of risk, and over time curtail significantly the use of illiquid and less liquid asset classes. The current and target asset allocations appear reasonable when placed alongside the liability and liquidity demands of the Plan's current benefit structure. The target asset allocation has the advantage of greater total fund risk mitigation and thus is more efficient in the pursuit of risk-adjusted returns than the current allocation.

Consideration of low or non-equity beta alternatives as potential additions to the target asset allocation would be a well-spent effort on further improving risk/return efficiency. Future expectations for asset class returns and risk change continually. Periodic reassessment of the Plan's asset allocation and the forward looking capital markets assumptions that it rests upon is the best practice.

Chairman Sowerby introduced Mr. Gus Sauter, Chief Investment Officer and Managing Director of Vanguard Institutional Asset Management. He asked Mr. Sauter to focus less on the economic environment and more on the good news in the capital markets – where opportunity by asset class is noted and where there may be less consensus-focus than the rest of the world.

Vanguard Institutional Asset Management – Mr. George U. "Gus" Sauter

Mr. Sauter began his presentation with the 30-seconds on the economic outlook, which it is believed the recovery is self-sustaining. However, there are a couple of trip wires; but two drivers behind the economy are the consumer and corporate investments. Consumer – employment continues to increase providing more money for consumers to spend and at the same time consumer's debt burdens have been reduced also providing an incentive to spend again. Corporate – corporate investment has been very light for the last three to four years. Corporations have a need to re-invest because of obsolescence; they have the ability because corporate income has been increasing dramatically and there is a very strong correlation between corporate investment and earnings growth. He noted in looking at the self-sustaining recovery, there are some dark clouds – European debt crisis, the Federal deficit which is more intermediate term in nature, the housing situation continues to be an overhang, and finally the last one would be oil prices. If oil goes to $140 per barrel, this could create a double-dip recession.

Mr. Sauter discussed equities which do not seem to be over-extended at this point in time. Equity valuations are reasonable, not cheap at this level, but not expensive either. He noted there are a lot of wild cards out there right now with Greece and Ireland and Portugal, they could really trip things up in the short run. But over a two to three year time horizon, it is believed equities will provide reasonable rates of return in line with historic rates of return – 9% or 10%. He referred to the chart in the presentation where the U.S. bond returns and U.S. equity returns are compared over a 10-year probability distribution. This is a product of an econo-metric modeling process in line with qualitative thinking as well.

Mr. Sauter talked about bonds, they believe that bond returns will be in the 3% to 3.5% range over the next decade given the low level of bond yields at the present time. Historic return rates have been in the 5% to 6% range. Bonds are a hedge against the volatility that comes from equities. He noted that a long time horizon greater than the duration of the investments will be better if the interest rates are higher. The desire is to have interest rates higher even if it will cause a short-term principal hit. Credit is desired within the bond arena. Credit spreads blew out in 2008, providing an attractive opportunity for crediting and expectations that the economy would continue to grow, albeit at a moderate pace. At the present time, the economy is expected to grow at 3% this year, strengthening in the second half, soft patch now. Also, a soft patch at the beginning of next year as well, strengthening in the second half of next year and again 3% next year.

Mr. Sauter noted that the economy is not overly robust, but it is one that continues to move forward and does so without creating undue inflation. It is not anticipated that short-term interest rates will increase for perhaps another year, probably the middle of next year at this point. Also, the intermediate and longer-term rates will back up in advance of the Federal Reserve taking position, which is usually the case. The public markets usually move before the Federal Reserve does. Rates have been coming down dramatically over the last month or so. At some point this will stabilize and within the next six months rates on the intermediate to long-range move a little bit higher. However, a bear flattening is anticipated, so shorter-term rates are expected to move much higher than longer-term rates because the yield curve is very steep right now and there is more room for short-term rates to move up. He noted that a lot of people are positioning at the short end of the yield curve in anticipation of a back up in rates. In fact, a dramatic principal decline in the short end could be seen because rates could move much more dramatically, they could back up four percentage point on a two-year duration. The other advantage of intermediate versus short-term right now is getting paid a lot for the carrot. He noted that as the economy continues to improve that credit spreads will continue to tighten and if the Treasury is back up, credit could back up, but not as much.

He discussed TIPS, noting that he is very worried about TIPS right now. The real yields are extremely low, real yields meaning 75 basis point range for the 10-year TIPS. He talked about emerging markets and why investors are weighting emerging markets heavily. He believes there is either a presumption of tremendous economic growth in emerging markets and/or greater returns. He noted that there is belief there will be greater economic growth in emerging markets even though India and China have made moves to slow down their economies, they will continue to grow at a very rapid rate. They have grown 9% to 10% a year for the last couple of decades. Unfortunately, there is no correlation between equity returns and GDP growth. He noted that financial theory would say that there is no correlation between economic growth and equity returns and there is compensation for taking risk. Equities are expected to return greater than bonds because they are more volatile, they are riskier. The market will adjust prices at the beginning to reflect that, so the expected return for equities should be higher than the expected return for bonds; but the expected returns for emerging markets over developed markets would, therefore, have to be linked to the risk of investing in emerging markets relative to developed markets. He concluded his presentation noting that the trade deficit, which is obviously significant, if highly driven by the dependency on oil; when oil goes up, the dollar goes down relative to the Euro; when oil goes down, the dollar rallies and that is what has been seen in the last four years, it is an extraordinarily strong correlation. The trade deficit will never be balanced until dependency on oil is reduced.

Chairman Sowerby thanked Mr. Sauter for this time and his presentation.

Investment Reports

Active Domestic Equity – Mr. Jack Behar reported on the SMRS' active domestic equity investments. The market value for the active domestic equity holdings as of March 31, 2011, was $18,049 million. He began by noting his presentation would be a review of the three internal funds, then touching on the small, mid, and large cap, and finish with a counter-consensus view on commodity-driven investments.

Mr. Behar first looked at the growth fund which was launched with a new portfolio manager on January 1, 2005. Since that time the growth fund has outperformed by 30 basis points annualized and on a five year basis, the growth fund is in the 45th percentile of active managers. Fees on the growth fund are about five basis points. Using 60 basis points as an estimate for peer group fees, the growth fund has outperformed by roughly 80 basis points net on a five-year basis. He moved to the core fund which has a very similar story – inception to date, the core fund has outperformed its benchmark by 28 basis points which is in the 59th percentile of all active managers on a gross basis. The value fund has struggled a bit inception-to-date, although on a three-year basis, it is outperforming its benchmark, the S&P 500 value.

Mr. Behar moved to the small, mid, and large-cap portfolios. He discussed how the charts provide a picture of why it is believed that large cap is more attractive than small cal and how the internal funds are positioned to add value relative to the large-cap benchmark. Normalized earnings yield for the internal portfolio is 7.3%, normalizing a payout ratio gives a dividend yield of almost 5% in the internal funds; these dividends are composed of both dividends paid and buy-backs. He noted in looking at the large cap versus the small cap, it is not just that the large cap has a lower PE, it is that small caps need to invest most of their money back into the business to grow. The dividend yield on small-cap stocks is roughly 0.5%. He noted that it is believed that there is more value in the internal portfolio than in the S&P 500 and the S&P 500 is the most attractive asset class right now. Mr. Behar stated that the internal portfolios have less volatility than the S&P 500. One reason for that and one of the reasons that a higher dividend yield is noted, is that a lot of the less risky companies have been neglected. The bond-like equities have been neglected.

Mr. Behar moved to commodities, which he stated is a counter-consensus view. He noted that the argument for commodity-driven investment is two-fold. One, that the Fed policy is inflationary with QE 2 and, second, that there is tremendous growth in the emerging markets. He explained his view: one, the Fed policy is not inflationary; and two, a lot of the growth that is noted in emerging markets over the past three years has been excess liquidity-driven, which has driven up commodity prices. He noted it is his belief that the excess liquidity cannot continue over the longer term. He stated that as far as the Fed policy, all of the expansion of the Fed's balance sheet has just offset a massive deleveraging by the banks. He noted Milton Freidman's biggest argument or biggest complaint about the Fed in 1930 was that while the banks were deleveraging the Fed did nothing, did not print any money; the M2 declined by 30% in the Great Depression because the Fed did nothing. He stated that Ben Bernanke learned that lesson and all the money that was printed by the Fed offset bank deleveraging. Over the past three years, the U.S. money supply growth in excess of normalized GDP is slightly over 2%. The U.S. from 1972 to 1977 grew its money supply by about 6% annualized over normalized GDP.

Mr. Behar discussed the M2 and that this is partially driven by what the Fed puts into the system, it is also driven by bank lending because there is a multiplier effect. So, when the banks stop lending, the money supply contracts. That is why it was important to save the banks. He explained that commodity prices have exploded because of what is going on in emerging markets. He believes the root cause of what is happening there is because of the currency peg. The currency peg, particularly in China is inherently inflationary. The other factor that has increased the Chinese money supply has been the huge lending binge that China ordered its banks to do in 2009 during the downturn. Over the past three years, China has almost doubled its money supply.

He discussed the labor rates in China, the rates are up 20%, but the U.S. consumer is not paying any more for product. Commodity prices are up, so import costs are up, tremendously impacting profitability. Chinese exporters have very, very slim margins. Commodity prices, if they go down, they give a little breathing room to the export industry; if they go up, it again puts more pressure on labor rates, more pressure on input costs, and there is risk to social stability. Some U.S. retailers are talking about relocating their operations away from China because of those costs. This creates an unemployment problem, so the Chinese government is in a difficult spot. He noted that many people do not realize that the Chinese export industry, if you look at the net exports, has declined as a percent of GDP, the economy is being driven by infrastructure at this point. He closed with a quote from Warren Buffett on Commodities, April, 2011: *"There are very few commodities where we know the direction of their movement in the next six months to a year,"* he said. *"People like to get in on things that are rising in prices. Over time, it has not been the way to get rich."*

Alternative Investments – Mr. Peter Woodford reported on the SMRS' alternative investments. The total market value as of March 31, 2011, was $10,553 million. He noted that the marked-to-market valuations increased 8% for the first quarter while all asset classes performed well, the mezzanine performed exceptionally well because of the dislocation in the capital markets in 2008 and 2009. The first quarter distributions were $890 million, the highest distributions in four years continuing the trend that was seen beginning the second half of 2010. There was one new commitment approved in the first quarter for $15 million to Arboretum Ventures which is an early-stage capital firm specializing in the health care sector. He noted that the actual allocation was at 20.6% with the target allocation of 14% a goal to continue to work toward.

Mr. Woodford reviewed the outlook noting that 2011 looks promising, particularly for exits; despite concerns of slower economic growth, the economy has stabilized, capital markets have improved, leverage is returning and exit opportunities are increasingly available through the IPO market, strategic sales and secondary transactions. The first quarter includes the three largest sponsor-backed IPOs in the industry's history – HCA, Kinder Morgan, and Nielsen Company. Last month LinkedIn went public and shares more than doubled setting the stage for other internet companies including Facebook and Groupon. He noted that anecdotal evidence points to a resurgence in buyout deal activity. These drivers include investment deadlines, cash-rich corporations, a strong financing market and buyout shops, which are hungry to do deals after three years of inactivity. The mid to lower end of the buyout market remains attractive, with smaller firms using less leverage and employing more operational expertise.

Mr. Woodford noted the distressed debt opportunities have diminished. The wall of debt maturities still exists, but ample liquidity and low default levels mean fewer investment opportunities and lower returns. Secondary market transactions experienced lower discounts to net asset values in the first half of 2011, which is an indicator of improved market conditions and valuations. Pricing has continued a slow move upward. He noted as the overall economy has gone from a crisis state to a slow-growth state, fundraising is showing nominal pickup. Fundraising in the first quarter was higher than in the first quarter of 2010, but still way off the historical peak of 2008. Mr. Woodford concluded his presentation noting that the first quarter of 2011 was a record quarter for distributions. The second quarter of this year, the pace has slowed down a bit, but overall the direction is good which is a result of the improved capital markets.

Fixed Income – The total market value for the fixed income portfolio as of March 31, 2011, was $7,453 million. Chairman Sowerby stated in the spirit of time the fixed income report will be received and filed.

Real Estate – The market value for the real estate portfolio as of March 31, 2011, was $4,474 million. Chairman Sowerby stated in the spirit of time the real estate report will be received and filed.

International Equity – The total international equity exposure as of March 31, 2011, was $7,265 million. Chairman Sowerby stated in the spirit of time the international equity report will be received and filed.

Indexed Domestic Equity – The market value of the indexed domestic equity portfolio as of March 31, 2011, was $6,103 million. Chairman Sowerby stated in the spirit of time the indexed domestic equity report will be received and filed.

Absolute and Real Return – The market value of the absolute and real return portfolio as of March 31, 2011, was $2,586 million. Chairman Sowerby stated in the spirit of time the absolute and real return report will be received and filed.

Basket Clause – The fair market value of the basket clause investments as of March 31, 2011, was $6,201 million or 12.073% of the total portfolio market value of $51.365 billion. Chairman Sowerby stated in the spirit of time the basket clause report will be received and filed.

Next Meeting Date and Adjournment

Chairman Sowerby asked for a motion to adjourn the June meeting and remind you that the next meeting is Thursday, September 1, 2011. A motion was made to adjourn by Mr. Roger Robinson and seconded by Mr. Steven Hilfinger. All were in favor. Meeting adjourned at 12:03 p.m.

Approved:

David G Sowerby

David G. Sowerby, Chairman