

2006 Financial Market & Retirement Board Performance Review

After a lackluster first half of 2006, investors began to sense in early summer that the Federal Reserve was close to achieving the elusive goal of a “Goldilocks” economy, one that is growing fast enough to foster impressive corporate profits but not rapidly enough to fan fears of inflation. The result of this increasing investor optimism, at a time when the world was awash with financial liquidity, was a “best of all worlds” investment scenario where every major asset class and sector posted positive returns for the year. Equities had their second best year of the decade in response to strong profit growth while bonds held their own as a result of lowered inflation expectations.

Equity Market

Thanks to the second half rally, the stock market enjoyed its fourth consecutive year of gains and the magnitude of those gains surprised most prognosticators. A significant fall in energy prices served to cool inflationary fears while bolstering consumer spending. The Fed halted its 2 ½ year program of raising short-term interest rates. Amid fair stock market valuations and the abundance of relatively cheap money, heavy stock buybacks and very active private equity funds contributed to a sense of unstoppable market momentum. Institutional investors who awaited a market correction never got their opportunity to jump in at cheaper levels.

For the year, the total return of the broad market Dow Jones Wilshire 5000 was 15.9%. The S&P 500 (large cap) index was up 15.8%, although it was still about 7% below its record high of March 2000. The technology-laden NASDAQ composite lagged, up only 9.5% for the year.

Perhaps the year’s biggest surprise was that small caps outperformed large caps for the eighth consecutive year. As it soared to a new record high, the Russell 2000 outpaced the S&P 500 by 2.6% in 2006. Over the trailing 3 and 5-year periods, the respective annualized return differentials in favor of small caps were 3.1% and 5.2%.

Investors had also expected that 2006 would be the year that growth stocks finally reversed the lengthy

run of out-performance by value. Alas, this wasn’t to be as, according to the Russell broad market indices, value outperformed growth by almost 13% in 2006, and by annualized differentials of 8%, 8%, and 6%, respectively, over the trailing 3, 5, and 10-year periods.

Among the S&P 500’s ten market sectors, telecommunications (+32.1%) and energy (+22.2%) led the way while information technology (+7.7%) and health care (+5.8%) lagged. Among major individual stocks, General Motors was the surprise leader, surging 58% off its depressed year-end 2005 level, while Intel, the leading semiconductor manufacturer, saw its stock fall 18% as the company faced intense competitive pressure within its industry. WalMart and Home Depot both registered declines of about 1% while Cisco (+60%), Exxon Mobil (+36%), and AT&T (+46%) had above-average gains.

Another trend that did not fade away during 2006 was the strong performance of international equity markets. Reflecting not only strong overseas earnings but also the effect of a weaker dollar (for example, the dollar weakened by 10.3% versus the Euro), the MSCI-EAFE Index was up 26.3% for the year in dollar terms. Reflecting the effect of currency translation, the respective gain was only 16.5% in local currency terms. In addition to the out-performance of 10.5% in 2006, MSCI-EAFE has outperformed the S&P 500 by 9.5% and 8.8% on an annualized basis for the trailing 3 and 5-year periods. Emerging markets recovered from an early correction to once again post impressive returns, up 32.2% for the year. Annualized returns have been 30.5% and 26.6% over the past 3 and 5-year periods.

European markets benefited from continued corporate restructuring and strong growth, with much of the growth being export-oriented. China and India were also fast growers, both in their internal economies and in trade. Russia, Brazil, and Venezuela were helped by trends in the commodity markets, while Latin American markets benefited from economic and political stability. The major disappointment in international markets was Japan, where economic growth and market appreciation both sputtered.

Fixed Income

The headline for 2006 in the fixed income markets was that, after 17 rate increases raising the Fed funds rate from 1.0% to 5.25%, the Fed halted its tightening program in June. It was also a year of record issuance in both the investment grade corporate bond market and in the high yield market as companies took advantage of rates that were still historically low to fund acquisitions, leveraged buyouts, and re-financings. Longer-term Treasury rates remained low and indeed lower than the Fed funds rate and other short-term rates in a trend (termed an “inverted yield curve”) that is often seen as a harbinger of recession. Nevertheless, in somewhat of a paradox, the yield differentials between Treasuries, corporate securities, and high yield bonds actually narrowed further in 2006, a trend that usually signifies optimism over the economy.

The ten-year Treasury note began the year at 4.39% and was as high as 5.25% in June, but yields generally declined over the second half after the Fed signaled its intentions. The yield was as low as 4.47% in early December but fell back to 4.71% at year-end. (Bond prices move inversely to yields.)

The Lehman Brothers Aggregate Index rose 4.3% for the year; among its components, mortgage-backed bonds and corporate bonds performed better than Treasuries. The Merrill Lynch High Yield Index enjoyed impressive performance of 11.6% as yield spreads narrowed and default rates remained low. Over the past five years, high yield had outperformed the Lehman Aggregate by 4.4% annually.

Other Asset Classes

While the slump in the residential housing market has been the subject of considerable media focus, the surprising strength in the commercial real estate market has received less fanfare. Massive financial liquidity amid a generally healthy economy has contributed to the robust condition of this asset class. Vacancies for office space are the lowest since 2001 and the price per square foot of space rose 17% last year, according to one survey. Prices paid not only have been surging for office space but they have also been rising for industrial and retail space. Reflecting these

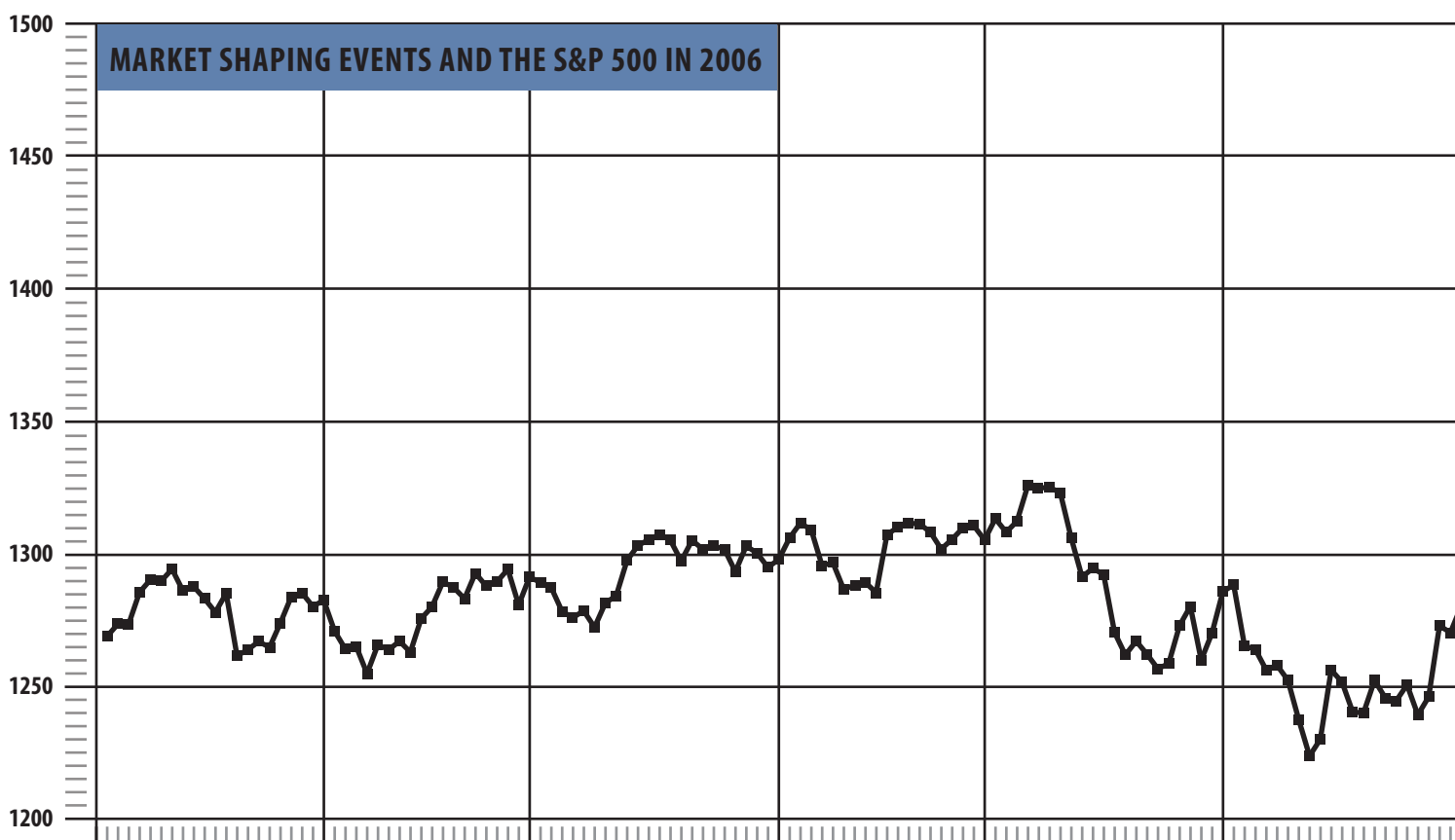
factors, publicly-traded equity Real Estate Investment Trusts returned an astonishing 35.1% in 2006. The annualized 3, 5, and 10-year returns for this sector have been 25.9%, 23.2%, and 14.5%. The year-end NCREIF Index return for private property investment was 16.6%; the annualized return over the past five years has exceeded 15%.

As previously noted, inexpensive stock valuations and cheap, abundant money have been the keys to the completion of many leveraged buyouts and have contributed to boom times for the private equity busi-

ness. Although conditions have improved, times have been less buoyant for the venture capital industry, where it is perceived that there is too much money chasing available deals, thereby raising the price and lowering expected returns from these deals. The still-lackluster market for initial public offerings has also had a negative effect. Both the number and dollar volume of venture-backed IPOs in 2006 were only about a quarter of the corresponding levels for 2000. The range of returns among alternative investments managers is always very wide and the publication of benchmark returns is significantly delayed. One-year

returns through September 30, 2006 (not including the market's strong fourth quarter) indicated performance of about 10% for venture capital and 23% for private equity.

Returns were solid but unspectacular for hedge funds in 2006. Performance varies significantly among the many distinct absolute return strategies and among managers, but aggregate hedge fund returns were in the range of 11-14%, higher than those of bonds but lower than those of equities. Returns for hedge fund of funds were in the range of 9.5% to 10.5%. In late



JANUARY

JAN 3 1268.80 ↑
JAN 31 1280.08 ↑

- Ford Motor Company has its credit rating lowered further into junk bond territory and announces plans to further slash jobs and close plants.
- IBM announces plan to freeze its defined benefit pension plan.
- Dow Industrials rise above 11,000 for the first time since 9/11/01.
- Exxon Mobil announces record fourth quarter earnings of \$10.7 billion.

FEBRUARY

FEB 1 1282.46 ↓
FEB 28 1280.66 ↓

- Federal funds rate is raised to 4.5% in Alan Greenspan's last meeting as Fed chairman.
- Sectarian strife increases in Iraq.
- BlackRock and Merrill Lynch Investment Managers announce plans to merge.
- Vice President Cheney accidentally shoots his hunting companion.

MARCH

MAR 1 1291.24 ↑
MAR 31 1294.87 ↑

- AT&T agrees to buy Bell South in a \$67 billion deal.
- General Motors increases the size of its 2005 loss due to recently-discovered accounting errors and reaches a major buyout and early retirement deal with its unions and major parts supplier.

APRIL

APR 3 1297.81 ↑
APR 28 1310.61 ↑

- GM raises cash by selling a majority stake in its profitable GMAC financing arm.
- Merck suffers three court setbacks related to its Vioxx drug.
- Oil rises above \$70 per barrel for the first time.
- US economic growth was a strong 4.8% in the first quarter.

MAY

MAY 1 1305.19 ↓
MAY 31 1270.09 ↓

- The Fed raises rates to 5% and the price of gold reaches \$704, its highest level since September 1980.
- More major companies are embroiled in the stock options scandal.
- Emerging markets suffer a big drop amid concerns over the economic outlook.
- Former Enron executives Lay and Skilling are convicted of fraud and conspiracy charges.
- Goldman Sachs CEO Henry Paulson is nominated as new US Treasury Secretary.

JUNE

JUN 1 1285.71 ↓
JUN 30 1270.20 ↓

- Insurgent leader al-Zarqawi killed by a bomb in Iraq.
- Bill Gates announces intention to give up his day-to-day role at Microsoft and Warren Buffet announces he will give most of his fortune to the Gates Foundation.
- The Fed's 17th rate increase, to 5.25%, turns out to be its last for the year.

summer, the industry suffered its largest individual meltdown since the Long Term Capital Management collapse in 1998 when Amaranth Advisors suddenly lost over \$6 billion, or about two thirds of its total assets, through speculative energy trading that went awry. Although a number of well-established funds of funds had invested in Amaranth, the fallout from this collapse was limited. The other major event from 2006 was a federal appeals court's invalidation of the SEC's plan to regulate hedge funds. Overall, the industry continued to grow, with up to \$1.4 trillion under management by some counts, with significant

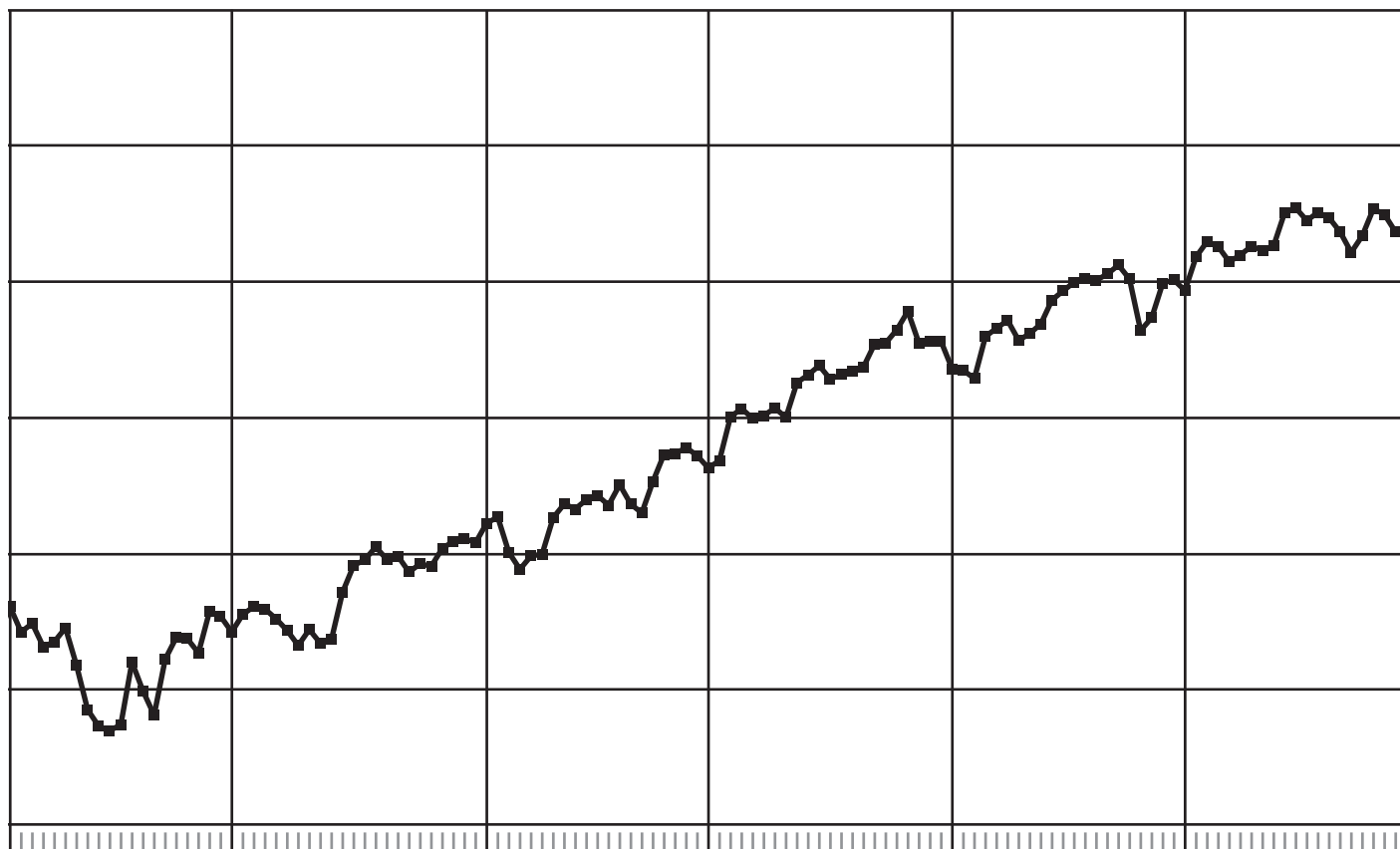
inflows from investors seeking returns uncorrelated with those of the major markets.

Looking Ahead

The markets entered 2007 with considerable momentum but also, as usual, with major uncertainties. Will the economy perform up to the optimistic expectations built into equity prices? Did 2006's strong second half "borrow" returns from 2007's first half? The stock market has advanced four consecutive years, but bull markets have rarely gone five years. Thanks in part to favorable weather, the price of oil was essentially

unchanged from the beginning to end of 2006, but will these conditions last? How much longer will corporate profit growth outpace GDP growth? Lulled into a sense of complacency, the major equity market indices continue to exhibit the lowest levels of volatility in several years, but how much longer will these conditions last?

As discussed here, all major asset classes, subclasses, and sectors had positive returns in 2006, but there was obviously a wide disparity in returns among all the categories. All retirement boards should have



JULY		AUGUST		SEPTEMBER		OCTOBER		NOVEMBER		DECEMBER	
JUL 3	1280.19	AUG 1	1270.92	SEP 1	1311.01	OCT 2	1331.32	NOV 1	1367.81	DEC 1	1396.71
JUL 31	1276.66	AUG 31	1303.82	SEP 29	1335.85	OCT 31	1377.94	NOV 30	1400.63	DEC 29	1418.30

- North Korea's test firing of missiles raises concerns.
- Mexico's presidential election results are disputed.
- Hundreds killed in terror attack in Mumbai, India.
- Oil reaches \$77 as Israel and Hezbollah clash in Lebanon.
- Economic growth slowed in the second quarter while consumer prices rose sharply.

- Congress passes a pension reform bill.
- Ford announces cutback in North American production of over 20%.
- Mideast hostilities end.
- Planet Pluto is demoted to dwarf status.

- 9/11 five-year anniversary is noted.
- Ford offers buyouts to all factory workers, eliminates its dividend, slashes more jobs, as Chairman Bill Ford relinquishes role.
- Hedge fund Amaranth Advisors implodes, losing over \$6 billion as a result of speculative energy trading.

- Falling oil prices help the Dow to reach a record high.
- Hewlett Packard Chairman and four other executives charged for roles in connection with company's leak probe.
- North Korea claims to have tested a small nuclear weapon.
- Google buys YouTube for \$1.65 billion.
- Chicago MERC-CBOT merger creates the world's largest exchange.
- Housing slowdown contributes to further decline in GDP growth.
- US population hits 300 million.

- Jobless rate falls to five-year low.
- Saddam Hussein sentenced to hang.
- Democrats recapture both houses of Congress.
- Defense Secretary Rumsfeld resigns.
- Delta Airlines rejects hostile bid from USAir.
- Legendary economist Milton Friedman dies at 94.

- Bank of New York and Mellon Financial merge.
- Iraq Study Group offers bleak view of war.
- Goldman Sachs reports Wall Street's most profitable quarter.
- Fidelity makes payment to some of its mutual funds in wake of gifts-to-traders controversy.
- New York State's Comptroller resigns after pleading guilty to misappropriating state funds.
- Former President Gerald Ford dies.
- So does Saddam Hussein, although under less dignified circumstances.
- The S&P 500 closes up 16% for the year, its best performance since 2003.

easily exceeded their target rates of return last year, but the extent to which they did so depended on their individual asset allocation and how their roster of investment managers performed.

As noted, last year saw the continuation of a number of investment trends and among them was the observation that the key to strong performance was to maximize portfolio diversification. In almost every instance, investments generally considered more risky outperformed their more conservative counterparts: small caps over large caps, international over domestic equity, emerging over developed markets, high yield over high grade bonds. Relatively illiquid asset classes such as real estate, alternative investments, and, to a lesser extent, hedge funds, all provided not only diversification but also attractive returns. Of course, in these nontraditional asset classes, it is particularly important to identify and gain access to the best possible managers.

2006 Performance Review and Analysis

As of December 31, 2006, the composite asset allocation for the 78 local systems that invested predominantly on their own was: 44.7% Domestic Equity, 15.6% International Equity, 1.1% Emerging Markets Equity, 23.9% Fixed Income (including high yield, TIPS, and international), 6.9% Real Estate, 0.2% Timber, 2.1% Alternative Investments, 2.7% Hedge Funds, 1.1% PRIT Core, and 1.3% Cash. Assets in these systems totaled \$17.7 billion. The composite allocation of these systems is consistent with reported average asset allocations from national surveys of state and local pension plans. Nevertheless, there is a wide divergence in our local systems' asset allocations compared to the composite levels. For instance, allocations to domestic equity ranged from 19% to 65% and allocations to international equity ranged from zero (five systems) to 39%. While several systems had allocation in excess of 10% to real estate, fourteen systems had no exposure to this asset class, including 6 systems with assets in excess of \$100 million. Forty systems had at least some exposure to alternative investments, but only 11 of these had meaningful allocations of 3% or more; 38 systems had essentially no exposure.

Twenty-six local systems with assets totaling almost \$2.0 billion invested entirely (or, in two cases, predominantly) with the PRIT Core Fund as of year-end. The asset allocation of that \$46.7 billion fund as of December 31, 2006, was 25.2% Domestic Equity, 3.5% Portable Alpha, 20.4% International Equity,

6.4% Emerging Markets Equity, 19.6% Fixed Income (including 10.0% US bonds, 4.7% TIPS and commodities, and 4.8% High Yield), 10.1% Real Estate (with leverage, 11.0%); 3.1% Timber, 6.5% Alternative Investments, and 5.1% Hedge Funds. In its below average allocation to domestic equities and above average exposure to non-traditional asset classes, PRIT's asset allocation is not typical of public pension funds nationwide. In addition to the 26 systems that invested essentially all their assets in the PRIT Core Fund, 12 systems had partial investments in the PRIT Core Fund and 40 systems participated in one or more of the PRIT Fund's segmentation options.

Performance for 2006 among the 104 local systems ranged from 7.52% to 18.09%. The median return was 13.99% and the composite return was 16.07%. For the 78 systems that invested on their own, the median return was 13.22% and the composite return was 13.94%.

The median return for the 26 local systems that invested totally with PRIT approximated that of the Fund itself, which was 16.72%. Internal cash positions or cash flows may have enhanced or subtracted from the returns of individual systems relative to PRIT's basic return. In recent years, a fundamental fact of institutional investing involving endowment funds, foundations, or pension funds, is that larger entities have performed better than smaller ones. Accordingly, the PRIT Fund's size has enabled it to invest meaningfully in a wider range of asset classes than many of the local systems, and its clout has enabled it to gain access to the top tier of managers in these nontraditional asset classes, particularly in alternative investments. Thus, the PRIT Fund's performance in 2006 was enhanced by its holdings in Alternative Investments, up 28.2%; Emerging Markets Equity, up 28.1%; and Real Estate, up 24.8%. PRIT's international equity investments provided a 26.6% return.

Although they've lagged behind the PRIT Fund, the local systems that invest on their own have, on the whole, still done well. As in previous years, the 2006 median return (13.22%) for the non-PRIT local public pension systems was within the range of the median returns of the public fund universes of several national databases: New England Pension Consultants public funds median, 13.5%; T.U.C.S., 13.2%; and Northern Trust public funds universe, 13.5%.

Among the non-PRIT systems, eight of the ten best performers had investment consultants (another had a consultant through the end of 2005) and the common characteristics of these systems were good-to-excellent performance by investment

managers and diversified asset allocation, highlighted by healthy exposure to international equity and real estate. Systems on this list included one of the smaller systems in the state as well as several medium-and larger-sized systems. Dramatically demonstrating that size is not necessarily a detriment if a board has a well-diversified asset allocation as well as strong portfolio managers, the \$27 million Clinton Retirement System—by achieving strong returns from international equity (+27%) and real estate (+37%) as well as from large cap value and small cap equity—not only led all the other local systems in 2006 but also outperformed the PRIT Fund. An additional four of the ten best systems also have less than \$100 million in assets. The fact that these ten systems, as well as several others, registered performance well above national public fund universe medians vividly demonstrates that there are no meaningful regulatory obstacles to boards achieving above-average performance.

Eight of the ten worst performing systems were relatively small systems, ranging in size from \$8.6 million to \$76 million in assets. Only three of these lagging systems used an investment consultant. Five of these systems had asset allocations that consisted totally of domestic equity and bonds; others had below average combined exposure to international equity, real estate, and other nontraditional asset classes. Two of these systems justify their conservative asset allocations by having high funded ratios, but others have no such rationale. Another common thread was disappointing returns from domestic equity, encompassing not only poor large cap stock selection but also insufficient exposure to the better performing small and mid-cap sectors. Some of 2006's lagging systems had been among the best performers in 2005 but suffered the downside of having one investment manager for all assets despite the fact that this manager's equity performance has been highly erratic over time. One system with reasonable asset allocation and a diversified roster of investment managers was dragged down by having a large cap growth manager, representing about two thirds of the system's domestic equity holdings, who recorded a negative return for the year.