



**2008 INVESTMENT REVIEW**  
**THE BOARD OF PENSIONS BALANCED INVESTMENT PORTFOLIO**

## **The Glad Game**

The 2008 return for the Board of Pensions Balanced Investment Portfolio was -28.6%. This is the worst return since the inception of the current portfolio in 1987. We will outline in great detail how this happened. This will not be an upbeat review for there is not much to be glad about, except that 2008 is over.

Eleanor Porter wrote Pollyanna in 1913. The novel is the story of a young girl who changes the lives of the people she encounters when she engages them in **The Glad Game**. Always making the best of bad situations, Pollyanna could even be glad to receive crutches instead of a doll for Christmas since she did not need the crutches.

In these times of global economic and financial market chaos, should we have the optimism of Pollyanna? Can we play **The Glad Game**?

## **Reasons To Be Glad**

### **The security of a defined benefit pension plan**

The 1986 design of the defined benefit pension plan and subsequent asset/liability studies incorporated multiple economic and investment scenarios, including the highly unlikely chance of a year with investment returns as negative as the one we have just experienced. Building such 100 year flood events into the design and funding of the plan means that despite the collapse in global markets in 2008, pension benefits are secure.

### **Strong portfolio liquidity**

The Board of Pensions Balanced Investment Portfolio has always been managed to maintain adequate cash and portfolio liquidity for the payment of benefits. In 2007, the Investment Committee reviewed a study that analyzed the impact of illiquid investments in the Balanced Investment Portfolio and approved a maximum 10% allocation to such investments. This new allocation limit and the guidelines already in place give the Portfolio strong liquidity during periods of extreme market volatility, such as those experienced in 2008.

### **Disciplined long-term asset allocation**

While burying cash in a box in your backyard might have been the best strategy for individual investors in 2008, the Investment Committee must maintain a long-term asset allocation and not overreact to changing market conditions. The Committee affirmed the long-term asset allocation at the October 2008 meeting and will rebalance as conditions warrant.

### **Partnerships we can be proud of**

We scrutinize every firm we invest with to be sure they are partnerships we can be proud of. We believe our rigorous processes prevent investing with fraudulent firms. A list of our investment partners is provided on page 26.

## **Reasons Not To Be Glad**

### **The worst performance in the history of the Board of Pensions Balanced Investment Portfolio**

We failed to meet both our absolute benchmark of Consumer Price Index (CPI) plus 5% and our relative or asset mix policy benchmark.

## A global financial collapse and recession in the U.S.

The year got off to a bad start with a global stock market decline in January. The Federal Reserve promptly reduced the federal funds rate twice in less than 10 days, for a total reduction of 1.25%. Sovereign wealth funds from Abu Dhabi, Singapore, Kuwait and South Korea invested more than \$33 billion in Citigroup and Merrill Lynch. Bear Stearns was bought by JPMorgan. Fixed income markets were paralyzed by complex derivatives as well as a glut of leveraged buyout bank loans that could not be sold to investors. Oil climbed to \$147 a barrel and gasoline topped \$4 a gallon in the U.S.

As bad as things were in the first half of 2008, the financial world as we knew it began to implode in September 2008. Over two successive weekends, U.S. mortgage giants Fannie Mae and Freddie Mac were placed into conservatorship by the U.S. government, Lehman Brothers filed for bankruptcy and regulators took over insurer AIG. While it appeared to start in the U.S., the seeds of the global collapse had been planted years before. Banks in the United Kingdom, Germany, Switzerland, and Iceland all held highly leveraged portfolios of complex, illiquid securities. As hedge funds tried to sell securities to raise cash for redemption requests and reduce portfolio leverage, highly volatile markets became totally illiquid. Money market funds had losses and could not provide shareholders with their cash. Governments cut interest rates and wrestled with creative ways to inject capital into banks to shore up sagging balance sheets and get loans out to individuals and corporations. As events continued to unfold in the fourth quarter of 2008, U.S. automakers flirted with bankruptcy and the U.S. government injected additional cash into banks.

People who had never wanted to open an economics text book learned about the dangers of leverage, the Paradox of Thrift, and that “we are all Keynesians now”, as the U.S. government allocated billions through TARP and other programs and the line between capitalism and socialism blurred.

## Introduction

The Board of Pensions Balanced Investment Portfolio returns net of fees and the asset allocation on December 31, 2008, were as follows:

	2008	<u>Asset Allocation</u>		Strategic
	<u>Return</u>	<u>\$ Millions</u>	<u>Percent</u>	<u>Asset Allocation</u>
U.S. Equity	(38.6)%	\$1,955	36.3	35-55%
International Equity	(40.5)	948	17.6	10-25
Fixed Income	(7.7)	1,935	35.9	25-45
Alternative Investments	(16.7)	<u>549</u>	<u>10.2</u>	1-15
<b>Total</b>	<b>(28.6)%</b>	<b>\$5,387</b>	<b>100.0%</b>	

Before we dissect 2008 investment performance, it is useful to review what we expected from markets in 2008. Unfortunately, some of our cautionary comments seem to have been right on the mark but markets were far worse than we forecast and we were too early in our implementation of inflation protection strategies. In our 2007 Review we wrote:

“The Investment Committee recognizes that a 5% real return objective will be difficult to achieve in the current global investment environment of low interest rates, narrow spreads, fair equity valuations with few bargains, and a tight supply/demand relationship for commodities essential

for current and long-term economic growth. We believe 2008 will provide returns that fail to meet our absolute benchmark of the Consumer Price Index plus 5%. We believe asset allocation and security selection will add value above a portfolio of passively managed index funds and that we will outperform our relative performance benchmark.”

**Comment: We did not exceed either benchmark in 2008 primarily due to fixed income performance.**

“We expect U.S. stock market performance in 2008 to range from negative 10% to positive 5%. International stock markets will have similar returns. We cannot expect weakness in the U.S. dollar to improve returns for U.S. dollar investors in most major international markets.”

**Comment: Equity returns were three times as bad as our worst case. A weak dollar improved our investment return in Japan but the stronger dollar resulted in lower return for U.S. dollar investors in most other international markets.**

“Fixed income returns will be low single digits in 2008. It will be difficult to outperform in the U.S. bond market in 2008. As spreads narrowed in 2007, the added value from taking risk in spread products, whether in high yield or emerging markets was reduced. Correctly positioning portfolio duration to achieve maximum benefit from Federal Reserve actions will again be critical to portfolio success in 2008. As the Federal Reserve continues to reduce the federal funds rate, the benefits of holding cash, other than for tactical allocation, will be diminished.”

**Comment: In the second half of 2008 investors wanted to avoid any credit risk and sought out the safety of the most liquid, highest quality securities, U.S. Treasuries. As spreads widened on corporate bonds, our holdings were negatively impacted.**

“The Investment Committee and staff will continue to focus on inflation and real return strategies that could help to maintain the purchasing power of our retirees in periods of inflation and stagflation.”

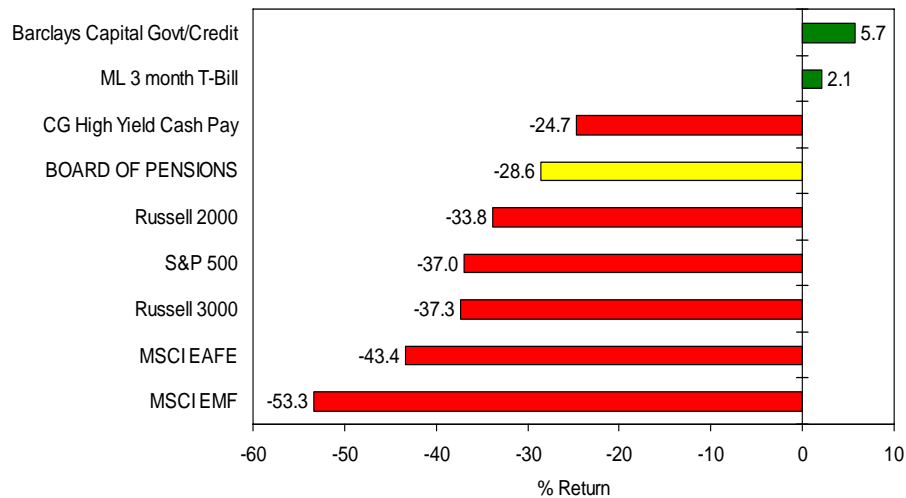
**Comment: Inflation was a significant concern in 2007 and the first half of 2008. We added portfolios of global REITs (Real Estate Investment Trusts) and inflation protection securities and commodities. As the price for oil declined from \$147 a barrel in June 2008 to below \$40 in December, the U.S. economy experienced a decrease in the Consumer Price Index (CPI) and investors began to fear deflation rather than inflation.**

## Summary of Financial Markets

Let’s see what markets did and how we positioned the portfolio. Virtually all asset classes had negative returns in 2008. The stocks of large companies, as represented by the S&P 500 Index, had a return of -37.0%, with small company stocks or the Russell 2000 Index returning -33.8%. Developed international markets, as represented in the MSCI EAFE Index, had a local currency return of -40.3%, but in July 2008 the dollar began to strengthen against the euro and other currencies, resulting in a return of -43.4% to U.S. investors. After seven years of providing investors with the best returns, stocks of companies in emerging markets provided the worst return of -53.3%.

It was a challenging year for active fixed income investors. One of the most profitable strategies would have been to invest in the Barclays Capital (formerly Lehman Brothers) Government/Credit Index, for a return of 5.7%. Most fixed income managers believed that the actions of the Federal Reserve would result in lower interest rates by the end of 2008, yet many did not correctly position their portfolios in the highest quality, longer duration securities. They not only missed the benefit of the rate decline, but gave up return by holding too much in corporate bonds in the second half of the year, when markets began to re-price risk, spreads widened and liquidity evaporated.

## Returns of Market Indices and Board of Pensions Balanced Investment Portfolio 2008



Sources: BNY Mellon, MSCI (net)

### What is the Structure of the Board of Pensions Balanced Investment Portfolio?

The Board of Pensions Balanced Investment Portfolio uses external investment management firms for the day-to-day investment of \$5.4 billion in assets. The Portfolio is unitized on a monthly basis and is the investment portfolio for the Pension Plan as well as other plans and programs administered by the Board of Pensions. The U.S. equity component of the Portfolio has 11 investment managers, plus market-based index funds. The international equity component has eight managers, including two managers focusing only on emerging markets. The fixed income component has eight managers, including one investing in high yield or below investment grade securities and one investing in emerging markets debt. The global balanced component uses one manager. Alternative investments include distressed debt, private equity, venture capital, natural resources, real return and real estate securities. There were commitments to 37 funds or limited partnerships on December 31, 2008. One investment manager was excused in 2008 and replaced with a new manager. Managers can be excused for changes in investment style and firm ownership as well as performance. Portfolio diversification is a function of the long-term expected return for each asset class, but also must include risk tolerance based on investment styles, liquidity and the potential firm risk for each investment manager retained by the Investment Committee.

Each year all separate account managers for the Board of Pensions Balanced Investment Portfolio are provided a list of those companies on the current divestment lists. The lists include those companies on the General Assembly Divestment Program for military and tobacco, as well as those companies whose primary businesses are in the alcohol and gaming industries. The Board of Pensions divestment policy does not force sales of companies newly added to the lists, which could reduce the investment return on the Portfolio. Instead the policy prohibits the future purchase of the securities.

**PERFORMANCE HIGHLIGHTS**  
**BOARD OF PENSIONS BALANCED INVESTMENT PORTFOLIO**  
**PERIODS ENDED DECEMBER 31, 2008**

	<u>Annualized Rate of Return</u>				
	<u>1 Year</u>	<u>2 Years</u>	<u>3 Years</u>	<u>5 Years</u>	<u>10 Years</u>
BOP U.S. EQUITY	-38.6	-19.1	-9.3	-1.8	0.2
Russell 3000 Index	-37.3	-18.8	-8.6	-2.0	-0.8
BOP INTERNATIONAL EQUITY	-40.5	-16.8	-4.2	3.9	4.4
MSCI All Country World Index ex US	-45.2	-19.9	-6.6	3.0	2.3
BOP FIXED INCOME	-7.7	-1.5	0.9	2.2	4.3
Barclays Capital Govt/Credit Index	5.7	6.5	5.6	4.6	5.6
BOP GLOBAL BALANCED	-29.5	-12.3	-4.6	0.6	3.7
World Balanced Benchmark*	-27.8	-11.2	-3.1	1.4	1.5
BOP PRIVATE PARTNERSHIPS	-6.6	7.9	13.1	13.4	16.2
Russell 3000 + 500 basis points	-34.2	-14.9	-4.3	2.6	3.8
BOP INFLATION / REAL RETURN	-34.7	-21.6	-12.7	--	--
Consumer Price Index + 500 basis points	5.1	7.1	7.2	7.7	7.5
<b>BOP BALANCED PORTFOLIO</b>	<b>-28.6</b>	<b>-12.0</b>	<b>-4.1</b>	<b>1.2</b>	<b>2.9</b>
BOP ABSOLUTE BENCHMARK					
Consumer Price Index + 500 basis points	5.1	7.1	7.2	7.7	7.5
BOP RELATIVE BENCHMARK					
Asset Mix Policy Benchmark**	-25.7	-10.4	-3.1	1.5	2.4

Notes:

Returns are net of management fees.

The Russell 3000 +500 basis points is calculated monthly and linked to provide an annualized number that will be different than the sum of the annual return of the Russell 3000 +500 basis points.

\* World Balanced Benchmark is calculated using 65% MSCI All Country World Index and 35% Barclays Capital Global Aggregate Index. Previously, the World Balanced Benchmark was calculated using 65% MSCI World Index and 35% Barclays Capital Global Aggregate Index. Prior to July 2002, the World Balanced Benchmark was calculated using 65% MSCI World Index and 35% Salomon Brothers World Government Bond Index.

\*\*Effective 1/1/2005, the Asset Mix Policy Benchmark is calculated using each asset class midpoint multiplied by its index.

The policy benchmark is:

U.S. Equity = 47.5% \* Russell 3000 Index

International Equity = 17.5% \* MSCI All Country World Index ex US (ACWI)

Fixed Income = 35% \* Barclays Capital Gov/Credit Index

Alternative Investments = 0

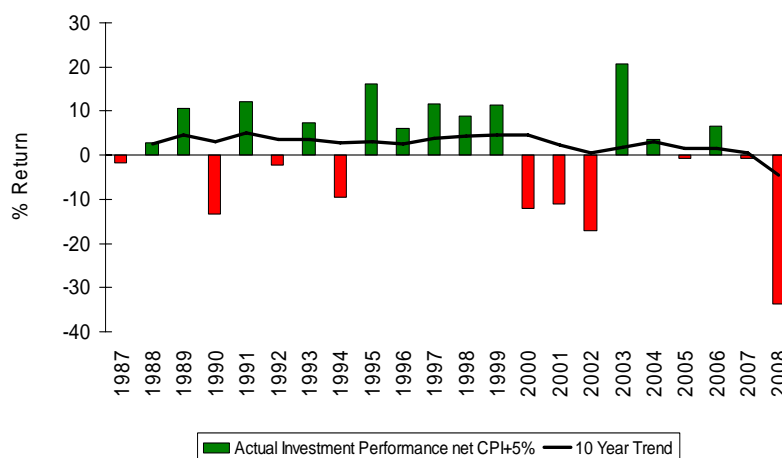
## Review of the Board of Pensions Balanced Investment Portfolio Performance

The Board of Pensions Balanced Investment Portfolio began 2008 with total assets of \$7.8 billion. The market value of the Portfolio decreased to \$5.4 billion on December 31, 2008. Performance of the Board of Pensions Balanced Investment Portfolio is measured against both absolute and relative benchmarks.

The absolute benchmark is unrelated to the performance of market indices. The long-term measure of success of the investment strategies of the Board of Pensions Balanced Investment Portfolio is a real return of 5%, or the Consumer Price Index (CPI) plus 5% annually. Market volatility over short-time periods, such as 2000 through 2002, and increased inflation makes the CPI plus 5% a difficult absolute return benchmark on an annual or short-term basis, but one that should be achievable over longer investment time horizons. The design of the Pension Plan assumes that over the long-term, the return of the Portfolio will meet or exceed the absolute benchmark. This should enable the Board of Pensions to maintain a well-funded Plan, capable of maintaining and increasing the promised benefits to Plan members. CPI in 2008 was 0.1% and the absolute benchmark of CPI plus 5% was 5.1%.

The graph below illustrates the long-term success of the Balanced Investment Portfolio in meeting the absolute benchmark. Bars above the line are those years when the difference between the actual return and the CPI plus 5% is positive. Bars below the line, such as 2008, are years when the actual return was lower than the absolute benchmark of the CPI plus 5%. The bar for 2008 was -28.6% minus 5.1%, or -33.7%.

### Investment Performance vs Long-Term Objective of CPI + 5% Annually

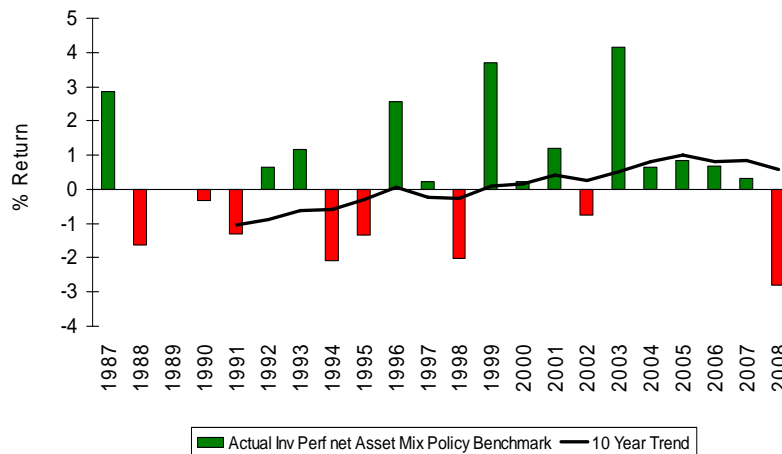


The relative benchmark is the asset mix policy benchmark that compares the performance of the Board of Pensions Balanced Investment Portfolio to that of investable market indices. The asset mix policy benchmark is the return the Portfolio would have achieved using the mid-point allocation to each basic asset class and the appropriate index return for that asset class. Above benchmark performance reflects the contribution of active investment management strategies and asset allocation decisions, including allocations to small capitalization stocks, high yield

bonds, emerging markets stocks, distressed debt, private equity and other alternative investments. Alternatives are not included in the benchmark since there are no investable market indices for private partnership alternative investments.

The graph for the Balanced Investment Portfolio returns compared to the asset mix policy benchmark should be read in the same manner as the previous graph with the absolute return benchmark of the CPI plus 5%. Bars above the line are those years when the difference between the actual return and the asset mix policy benchmark is positive. Bars below the line are years when the actual return was lower than the policy benchmark. The bar for 2008 is -28.6% actual returns less -25.7% for the asset mix policy benchmark return or a shortfall of 2.9%.

**Investment Performance vs Asset Mix Policy Benchmark**  
Actual Investment Performance net Asset Mix Policy Benchmark



## Performance Attribution

The underperformance of the Board of Pensions Balanced Investment Portfolio compared to the asset mix policy benchmark can be attributed primarily to fixed income performance and active asset allocation decisions. The U.S. equity component lagged the benchmark of the Russell 3000 while international equity exceeded the benchmark. Active fixed income was a significant detractor, underperforming the benchmark index. The alternative investment component, comprised primarily of distressed debt and private equity limited partnerships, added value. Asset allocation decisions made by staff and the Investment Committee to overweight high yield bonds and introduce inflation protection strategies contributed to the 2.9% of total portfolio underperformance against the asset mix policy benchmark.

**2008 PERFORMANCE ATTRIBUTION  
BOARD OF PENSIONS BALANCED INVESTMENT PORTFOLIO  
vs ASSET MIX POLICY BENCHMARK**

U.S. Equity	-0.49 %
International Equity	+0.82
Fixed Income	-3.31
Global Balanced	-0.32
Alternative Investments	+0.91
Asset Allocation/Cash Flows/Timing	<u>-0.51</u>
<b>Net Impact on Portfolio Performance</b>	<b>-2.90%</b>

## Asset Allocation

The Balanced Investment Portfolio was rebalanced throughout 2008, as we reduced our allocation to asset classes and managers with the greatest outperformance or with the lowest expected returns in 2008 and 2009. We trimmed our exposure to high yield bonds and emerging markets equities, although in hindsight we should have reduced more aggressively. We reduced our U.S. value managers, but not enough to mitigate the impact of their heavy exposure to financials. We increased liquid alternative investments in inflation protection strategies as oil and commodity prices were increasing. Cash was used for benefit payments and the funding of commitments to distressed debt and private equity.

**COMPARATIVE ASSET ALLOCATION  
BOARD OF PENSIONS BALANCED INVESTMENT PORTFOLIO**

	<u>December 31, 2008</u>		<u>December 31, 2007</u>	
	<u>\$Millions</u>	<u>Percent</u>	<u>\$Millions</u>	<u>Percent</u>
Equity	<u>2,903</u>	<u>53.9</u>	<u>\$5,016</u>	<u>64.1%</u>
U.S. Equity	1,955	36.3	3,398	43.4
International Equity	948	17.6	1,618	20.7
Fixed Income	<u>1,935</u>	<u>35.9</u>	<u>2,201</u>	<u>28.1</u>
Alternative Investments	<u>549</u>	<u>10.2</u>	<u>607</u>	<u>7.8</u>
Private Partnerships	453	8.4	406	5.2
Inflation/Real Return	96	1.8	201	2.6
<b>Total</b>	<b>\$5,387</b>	<b>100.0%</b>	<b>\$7,824</b>	<b>100.0%</b>

## U.S. Equity Performance

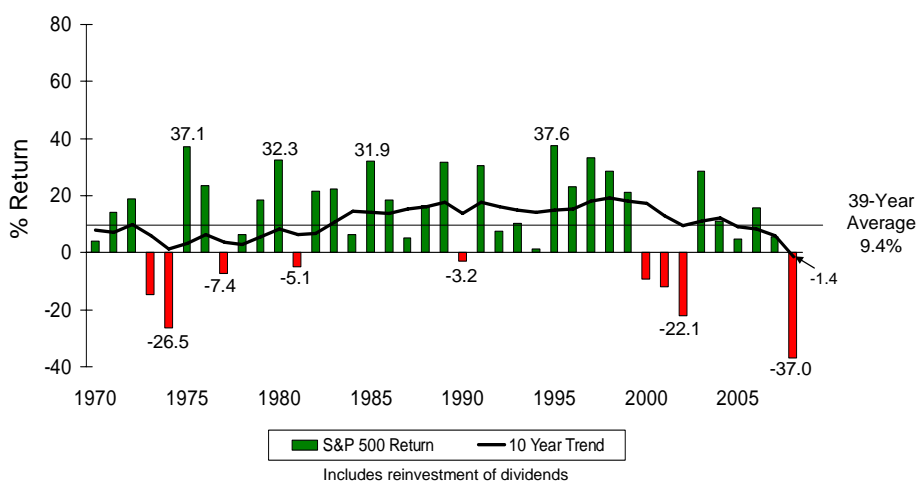
The U.S. equity component of the Board of Pensions Balanced Investment Portfolio had a -38.6% return in 2008, compared to the -37.3% return of the Russell 3000 Index. The large capitalization component of the Portfolio returned -37.3%, in line with the -37.0% return of the S&P 500 and -37.6% return of the Russell 1000. The small and mid capitalization component of the Portfolio returned -42.4%, significantly worse than the Russell 2000 return of -33.8% for small company stocks.

## U.S. Equity Market Historical Performance

The Russell 3000 Index includes stocks of large and small companies and is a broader measure of the U.S. equity market than the S&P 500. However, the Russell 3000 originated in 1984, so it does not have the historic data often valuable for long-term investment perspective. The S&P 500, though not as broad-based, offers important longer-term data and is used in the following two graphs.

The U.S. equity market, as measured by the S&P 500 Index, had a -37.0% return in 2008. As shown on the graph below, the -37.0% return is below the -1.4% average return of the last ten years, and the long-term 39-year average return of 9.4% for the S&P 500 since 1970. While the S&P 500 Index declined by 37.6% over the three years 2000 through 2002 and 37.4% over 1974 and 1975, the 2008 return of -37.0% is the worst single year since the -43.3% return in 1931.

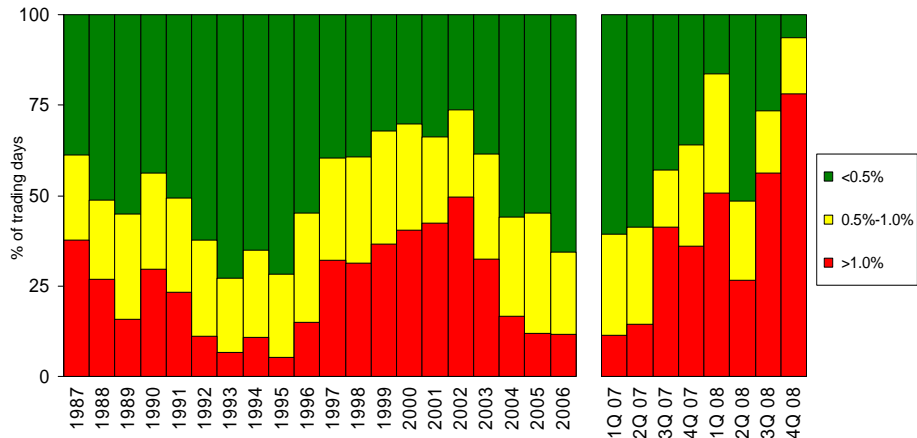
### U.S. Equity Returns in Historical Perspective January 1, 1970 – December 31, 2008



## Market Volatility

As global financial markets collapsed in the fourth quarter of 2008, the daily volatility of stocks in the S&P 500 Index significantly increased. The chart on the next page portrays the daily movement of the S&P 500, based upon the change in daily closing price from one trading day to the next. The graph divides market movements into three categories. The red or bottom bars are periods of high volatility, with daily movement of the index greater than one percent. The green or top bars are periods with lower volatility, when the index moved up or down less than one-half percent. As an example, in 1995, 5.2% of all trading days had a daily price change of greater than one percent. Volatility was low in the first half of 2007, as it had been for the three preceding years. In the first quarter of 2007, 11.5% of trading days had a daily price change greater than one percent. However, by the fourth quarter of 2007, 35.9% of trading days had a daily price change greater than one percent. Market volatility decreased in the second quarter, then accelerated in the third and fourth quarters of 2008. During the fourth quarter of 2008 as investors tried to sell stocks into a falling stock market, 78.1% of trading days had a daily price change of greater than one percent.

## U.S. Equity Market Volatility Daily Movement of S&P 500 Index



\* Daily closing value of S&P 500 as compared to prior trading day's closing value. Does not differentiate between movements up or down. Does not reflect intraday movements.

### Market Capitalization and Style

Investors know that the size of the companies they invest in, or the market capitalization, can significantly impact portfolio success. Small company stocks in the Russell 2000 Index returned 3.0% annually for the ten years ended December 31, 2008, exceeding the -1.4% return of large company stocks in the S&P 500. However, the time periods mask years of significant over and underperformance. Large company stocks outperformed from 1994 through 1998, while small company stocks provided superior returns from 1999 through 2006. While growth stocks outperformed in 1998 and 1999, value stocks were the winners for seven years from 2000 through 2006. In 2007, large and growth turned the corner and provided the best returns but the trend reversed again in 2008, with value and small providing better performance. The value/growth advantage was only 1.5% for larger companies, increasing to 9.7% for small companies, as shown in the table below.

#### 2008 U.S. STOCK MARKET PERFORMANCE BY MARKET CAPITALIZATION AND STYLE

Russell 3000 – Total Market	-37.3%	
S&P 500 Index (Large Cap)	-37.0	
Russell 1000 Index (Large Cap)	-37.6	
Russell Mid Cap Index	-41.5	
Russell 2000 Index (Small Cap)	-33.8	
Russell 1000 Growth Index	-38.4	{ 1.5
Russell 1000 Value Index	-36.9	
Russell Midcap Growth Index	-44.3	{ 5.9
Russell Midcap Value Index	-38.4	
Russell 2000 Growth Index	-38.6	{ 9.7
Russell 2000 Value Index	-28.9	

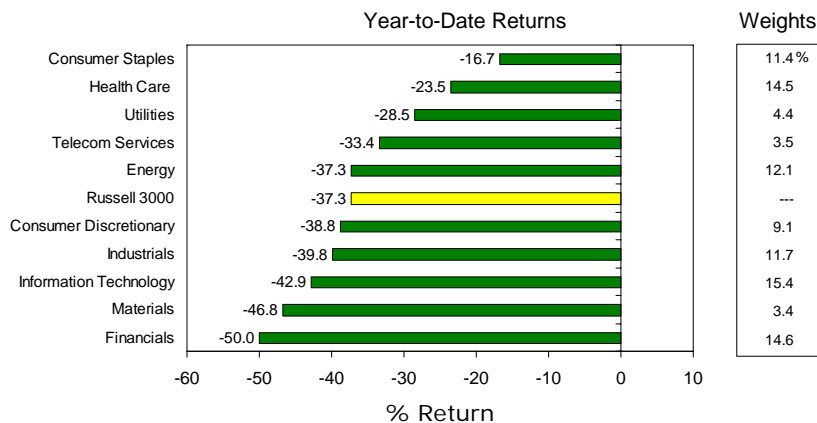
Data Source: Aronson + Johnson + Ortiz, LP, Vestek Systems

## Sector Performance

The U.S. stock market, as represented in the Russell 3000 Index, had a return of -37.3% in 2008. This was a year when sector selection and individual stock selection did matter. Companies in the energy and materials sectors were the best performers in the first half of 2008, but the stock prices of companies in the energy and materials sectors like Massey Energy and Peabody Energy ended 2008 down more than 60% as the price of oil and other commodities sharply declined in the second half of the year. On December 31, 2007, consumer staples represented 9.0% of the Russell 3000 Index, increasing to 11.4% of the Index by the close of 2008. The worst performing sector for the second year in a row was financials. Financials made up 14.6% of the Index on December 31, 2008, down from 17.6% a year earlier. While a few financials such as Well Fargo, with a return of -2.4%, managed to exceed the 50.0% decline of the financials sector, many others, including Citigroup, MBIA, Merrill Lynch and Wachovia closed the year down more than 75.0%. Many financial entities such as Fannie Mae, Freddie Mac and Lehman Brothers virtually ceased to exist, while others such as Washington Mutual were acquired by stronger banks. While financial companies dominated the headlines for most of 2008, the stock market collapse impacted virtually all sectors. While not owning financials would have improved portfolio performance in 2008, the Russell 3000 Index excluding financials would have returned a still dismal -34.6%.

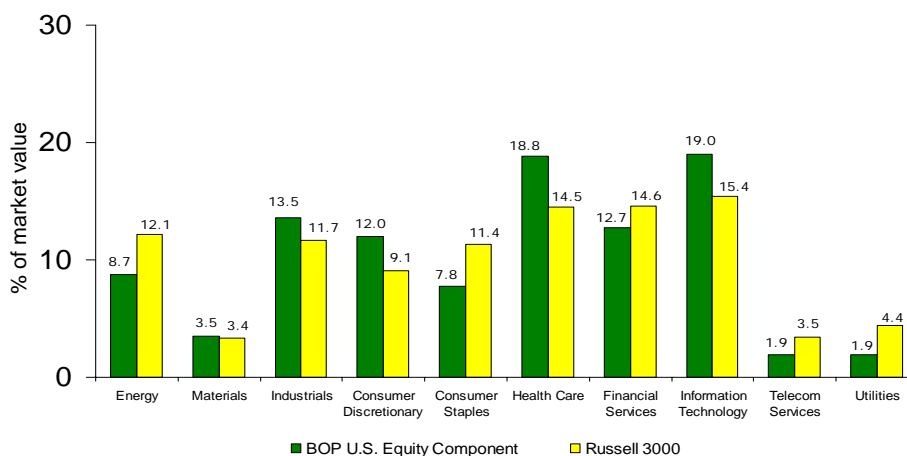
The Balanced Investment Portfolio had broad sector diversification in 2008. While not necessarily in the Balanced investment Portfolio for the entire year, on January 1, 2008 the top ten stocks in the U.S. equity component of the Portfolio and in parenthesis the 2008 stock return, were Microsoft (-45.4%), General Electric (-56.3%), Hewlett Packard (-28.1%), AIG (-97.3%), Exxon Mobil (-14.9%), Cisco (-39.8%), Schlumberger (-57.0%), Procter & Gamble (-15.8%), Monsanto (-37.0%), and Wellpoint (-52.0%). These top ten holdings were a diverse representation from the consumer staples, health care, energy, information technology and materials sectors. While we had only one financial stock in the top 10 holdings, AIG was held by several managers and was a significant loss in the Portfolio. In a year as devastating as 2008, sector diversification and investing in what were believed to be the highest quality firms with a history of earnings stability and growth did not preclude a return of -38.6% on the U.S. equity component of the Balanced Investment Portfolio.

### Russell 3000 Index Sector Returns and Weights December 31, 2008



If we explore the composition of the U.S. equity component of the Board of Pensions Balanced Investment Portfolio compared to the sectors of the Russell 3000 Index, as shown on the chart below, we can see that the Portfolio's U.S. equity component, based upon sector allocations, does not look like the Russell 3000. Active portfolio managers made active stock selections and the Portfolio reflects those over and under allocations to each sector. The Portfolio U.S. equity component return of -38.6% lagged the -37.3% return of the Russell 3000. Some sector allocations helped, others hurt. An underweight in financials, the worst performing sector, was a help, while an overweight in information technology, the second worst sector, detracted from performance. While the Portfolio had an overweight in health care stocks, the second best sector, we would have had better performance with a higher allocation to consumer staples, the best sector, with companies like Family Dollar, Wal-Mart and McDonald's providing positive performance in 2008.

### Total U.S. Equity Component Characteristics Sector weights vs Russell 3000 Index December 31, 2008



### Composition of the U.S. Equity Component of the Balanced Investment Portfolio

Active portfolio managers select individual stocks based upon valuations and expectations for future growth. Many of the best managers call themselves “benchmark agnostic”, meaning they are aware of a benchmark but don’t select stocks or sectors based upon the weighting in a benchmark. It is important to remember that the composition of most indices is backward looking, since it reflects the performance of prior periods. The weighting of an individual stock and its sector in most indices is based upon share prices, so if a stock or sector increases in weighting, it is because of strong past performance. When you buy an index fund, you are buying more of the recent winners, and less of the recent losers. Since active managers try to anticipate the next winners, the stocks and sectors in their portfolios can differ significantly from an index.

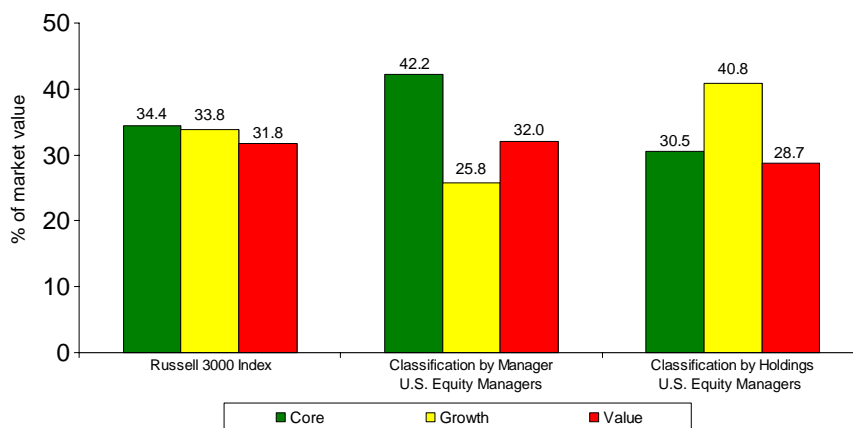
As shown on the graph on the next page, on December 31, 2008, the Russell 3000 Index contained stocks that were classified as core (34.4% of stocks in the index), growth (33.8%) and value (31.8%). The index is rebalanced annually and stocks can move from value to growth and vice versa. The procedures for the construction of the Russell indices resulted in the stock

of Merck, historically a growth company, being assigned to the value index, while Alcoa, formerly viewed as a value stock, went into the growth index.

A comparison of the structure of the U.S. equity component of the Balanced Investment Portfolio to the Russell 3000 Index by manager gives a very different picture of portfolio structure than a comparison by actual portfolio holdings. When the U.S. equity component of the Portfolio is classified by manager benchmarks, such as core, growth and value, the Portfolio has a 42.2% allocation to core managers, 25.8% allocation to growth managers and at 32.0%, an outsized allocation to value managers. On the surface, this analysis could lead a portfolio strategist to reduce the allocation to value managers and increase the allocation to growth managers.

A review of the actual Portfolio holdings by stocks presents a different picture, with active managers invested 30.5% in core stocks, 40.8% in growth stocks and only 28.7% in value stocks. In late 2005 and throughout 2006, Board managers reduced their exposure to value stocks that had six years of outperformance and began to purchase core and growth stocks that had underperformed in recent years. While this shift in exposure led to underperformance against benchmarks in 2006 when growth continued to lag value, it helped performance in 2007. In 2008 performance suffered when value stocks, excluding financials, outperformed growth stocks.

### **Growth/Value Characteristics U.S. Equity Component as of December 31, 2008**



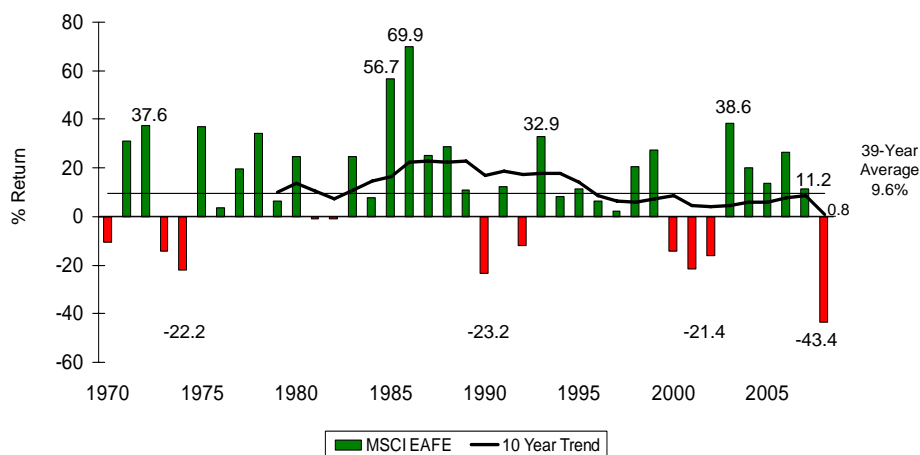
## **International Equity Performance**

The international equity component of the Board of Pensions Balanced Investment Portfolio returned -40.5% in 2008, compared to a -45.2% return for the MSCI All Country World Index ex US. While individual stock selection contributed to above benchmark performance, country allocation and currency were also critical factors in performance. Several of our managers had above benchmark allocations to Japan, one of the best performing markets in 2008, with a return of -29.2%. A strong yen contributed to improved performance in Japan for U.S. investors. Hedging against the strengthening dollar proved to be an effective strategy in the second half of 2008. Our own asset allocation decisions in emerging markets worked in our favor. We rebalanced the international component of the Portfolio several times in 2008 and reduced the allocation to emerging markets managers in the first half of the year.

## International Equity Historical Performance

The developed international equity market, as measured by the MSCI EAFE Index, had a -43.4% return in 2008. As shown on the graph below, the return is significantly below the 10-year trend line return of 0.8% and below the long-term 39-year average return of 9.6% for the MSCI EAFE since 1970. “De-coupling” is an investment term that implies global markets will act independently and returns will no longer be as closely correlated as in the past. Based upon 2008 investment performance, we have no reason to believe that de-coupling has occurred since the fourth quarter 2008 market collapse impacted virtually all global markets. Investors should remember that international markets declined a cumulative 43.3% for the three years 2000 through 2002, compared to the 37.6% decline in the S&P 500 for the same period and had a -33.2% return from 1973 through 1974 compared to the -37.4% return of the U.S. market.

### International Equity Returns in Historical Perspective January 1, 1970 – December 31, 2008



## Market Performance in 2008

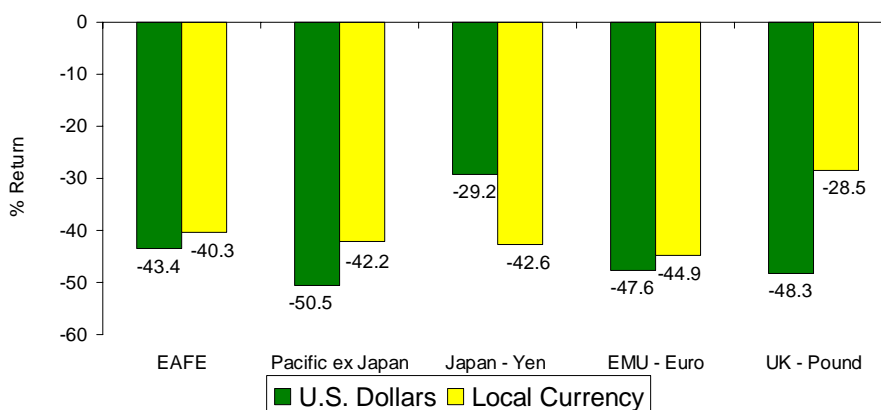
International stock returns in 2008 depended on both country and stock selection but, as shown in the table on the next page, currency was also an extremely important component of superior returns for U.S. dollar investors. While a weaker U.S. dollar makes imported goods and vacations abroad more expensive for Americans, it helps our export industries and improves our returns as U.S. dollar investors in stocks of companies based in those countries. The Japanese yen strengthened by 23.2% against the dollar in 2008. The weakness of the dollar significantly improved investment performance from -42.6% for Japanese investors to -29.2% for U.S. investors.

Other currencies weakened against the U.S. dollar, resulting in lower investment returns for U.S. dollar investors. The British pound depreciated by 26.5% against the U.S. dollar. This meant that an investor in a basket of stocks based in the United Kingdom and valued in British

pounds had a return in 2008 of -28.5% while the U.S. dollar investor in the same stocks had a return of -48.3%.

The euro showed a decline of -4.3% for the full year but this masked the almost 20% decline from one euro for \$1.58 in March to a low of one euro for \$1.27 in November. In a reversal of 2007 and the first half of the year, weak commodity prices in the second half of 2008 contributed to the weakness of many currencies. The Brazilian real depreciated by 23.1% against the U.S. dollar and the Canadian dollar declined by 18.6%.

### MSCI EAFE Developed Markets US Dollar Returns vs Local Returns 2008 Returns

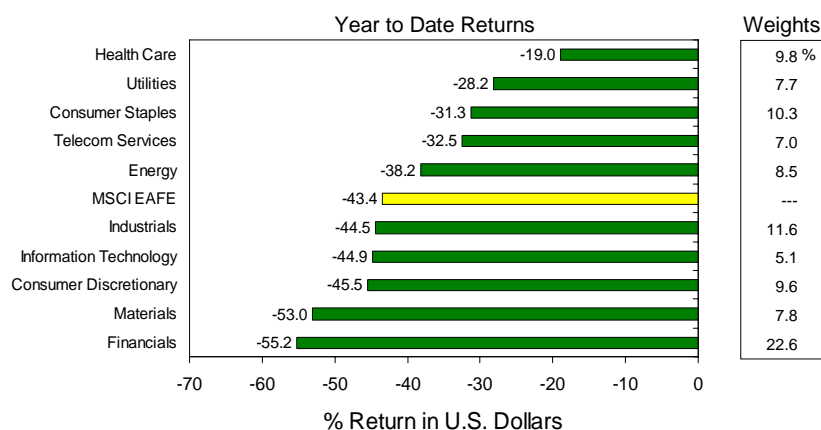


Source: MSCI (net)  
EMU: European Monetary Union

### Developed Market Performance

Financials were the worst performing sector in the MSCI EAFE Index, with a return of -55.2%. Bank failures in the United Kingdom, Switzerland, Germany and Iceland resulted in government bailouts and a collapse of the financial sector. While the weighting of financial stocks declined from 26.9% of the EAFE Index at the close of 2007 to 22.6% on December 31, 2008, financials remained the largest component of the Index. Industrials, at a 11.6% sector weight is the next largest sector of the EAFE Index, yet is only half the weight of financials. The EAFE Index has less sector diversification than the Russell 3000. Information technology, 15.4% of the Russell 3000 has only a 5.1% weighting in the EAFE Index. Health care, at 14.5% is almost the same sector weight as the financials 14.6% weighting in the Russell 3000 Index, yet health care is only 9.8% of the EAFE Index.

## MSCI EAFE Index Sector Returns and Weights December 31, 2008



Source: MSCI (net)

Country allocation was critical for success in 2008. Just as Japanese equities dominated the MSCI EAFE Index in the 1980s, stocks of U.K. and European companies had driven developed market index returns until 2008. Manager allocation to countries in the MSCI EAFE, whether low allocation to Japan in 1989 or a high allocation to Japan in 2008, was critical to successfully meeting or exceeding the return of the MSCI EAFE.

### MSCI EAFE INDEX Year-End Weight as a Percentage of Index

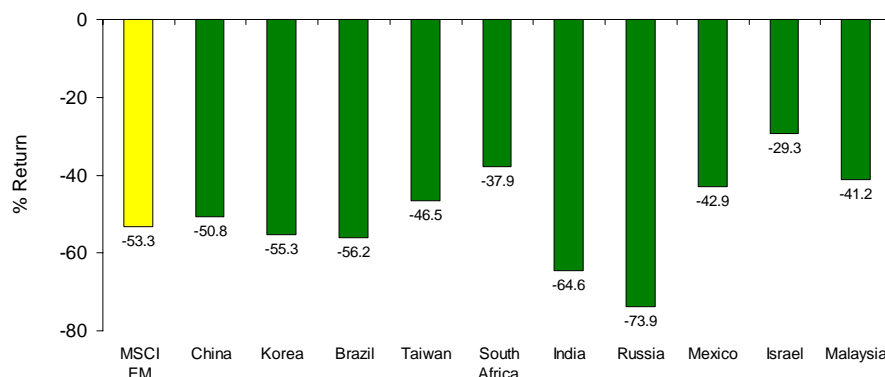
	<u>2008</u>	<u>1997</u>	<u>1989</u>
Europe ex U.K.	45.7%	45.6%	12.3%
United Kingdom	19.9	21.6	12.5
Pacific ex Japan	9.1	7.6	4.2
Japan	25.3	25.2	59.8

### Emerging Markets Performance

While most economists believe the long-term investment rationale for investing in emerging markets remains intact, emerging market countries were impacted by the collapse in global credit and the slowdown in the developed economies. The fall in oil prices from \$147 a barrel in June, 2008 to below \$40 in December created currency problems for commodity exporting countries such as Brazil and Russia. Stocks in three of the four “BRIC” countries, Brazil, Russia and India, had country index returns in U.S. dollars that were worse than the MSCI Emerging Markets Index return of -53.3%. China had a return of -50.8%. In 2003, the BRIC countries were identified by economists and investment bankers as those emerging countries with large populations and the ability to achieve rapid economic growth that could potentially eclipse many European and Asian developed market economies by 2050. While historic experience has often seen emerging countries as users of capital from developed countries, the reverse continued to be the case in 2007 and the first half of 2008. Many developing countries, including China, were net creditors to the rest of the world, as they used their trade surpluses to

set up Sovereign Wealth Funds and increase their overseas investments. This was particularly true for countries exporting oil and other commodities. A global slowdown, or recession in some countries like the U.S. and United Kingdom, will impact the growth rates of emerging market countries as export led growth is reduced.

### Ten Largest Emerging Market Countries by Market Capitalization 2008 Returns in U.S. Dollars



Source: MSCI Emerging Markets Index (with dividends reinvested, net)

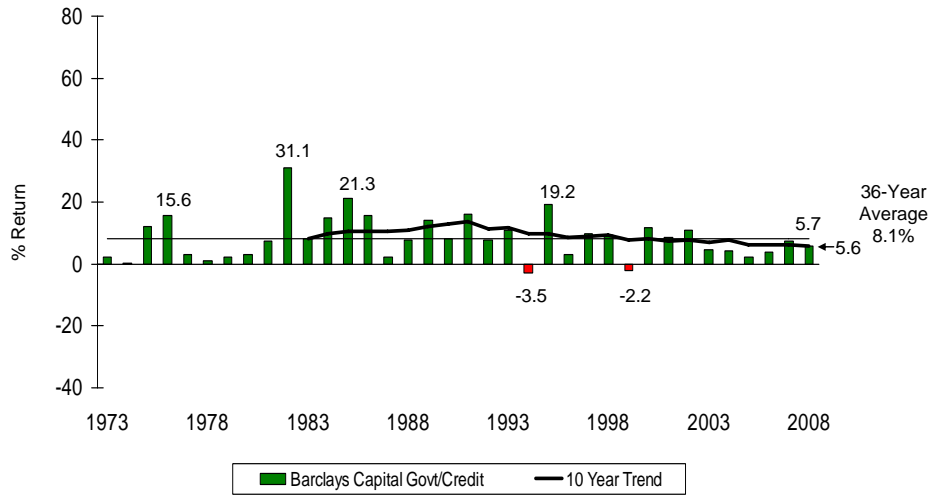
## Fixed Income Performance

In 2008, performance of the fixed income component was the major detractor from the return of the Balanced Investment Portfolio. The fixed income component of the Portfolio decreased by 7.7% compared to the benchmark return of 5.7% provided by the Barclays Capital (formerly Lehman Brothers) Government/Credit Index. The Portfolio duration at year-end of 4.9 years was shorter than the 5.4 years of the Barclays Capital Government/Credit Index but longer than the 3.7 years of the Barclays Capital Aggregate Index. None of the four Portfolio core fixed income managers outperformed the 5.7% return of the Barclays Capital Government/Credit Index. While none of these active managers held credit default swaps or subprime debt, the return of the Portfolio fixed income component was reduced due to managers incorrectly positioning portfolio duration throughout 2008 and holding corporate bonds and mortgage backed securities that declined in value when spreads widened in the second half of the year. While we reduced the allocation to high yield in the first half of 2008, and the -21.8% return of our dedicated high yield manager exceeded the -24.6% return of its benchmark index, the allocation to high yield negatively impacted the fixed income component return. Performance of the fixed income component of the Portfolio was also negatively impacted by the allocation to emerging market debt.

## Fixed Income Market Historical Performance

The chart on the next page provides the historical performance of the U.S. fixed income market, as represented by the returns of the Barclays Capital Government/Credit Index. Investors in fixed income often experience negative returns during periods of rising interest rates or when spreads widen on corporate bonds and other types of credit based instruments. Over the last 10 years, as shown on the 10-year trend line on the graph, the Barclays Capital Government/Credit Index had a return of 5.6%, below the 36-year average return of 8.1%.

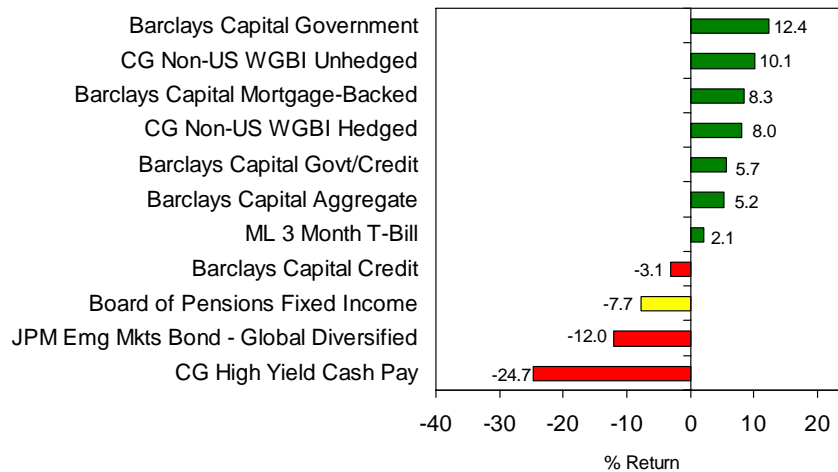
## Fixed Income Returns in Historical Perspective January 1, 1973 – December 31, 2008



### Investment Performance

Bond performance depends on multiple factors but usually the most important ones are the level and direction of interest rates, portfolio duration, credit quality and investor appetite for risk, as reflected in the spread over U.S. Treasuries for corporate bonds. In 2008 safety and liquidity were most important. As shown in the graph below, in 2008 the best strategy would have been to invest in the Barclays Capital U.S. Government Index for a return of 12.4%. The worst performance, -24.7%, was from the Citigroup High Yield Index.

## Fixed Income Index Returns 2008

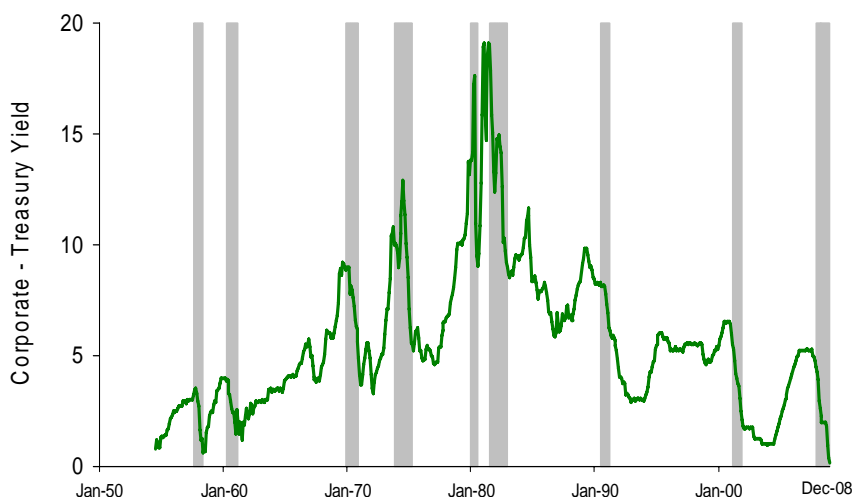


Source: BNY Mellon

## Interest Rates

The Federal Reserve's target for the federal funds rate was 4.25% at the start of 2008. This is the interest rate at which private depository institutions, primarily banks, lend balances at the Federal Reserve on an overnight basis to other depository institutions. The graph below provides a long-term history of the federal funds rate. In June 1981 the rate peaked at 19.1% while the July 1958 rate of 0.68% was the low prior to 2008. After six reductions in the first ten months of 2008, on December 16 the Federal Open Market Committee made the unprecedented move of setting the funds target rate in the range of zero to 0.25%.

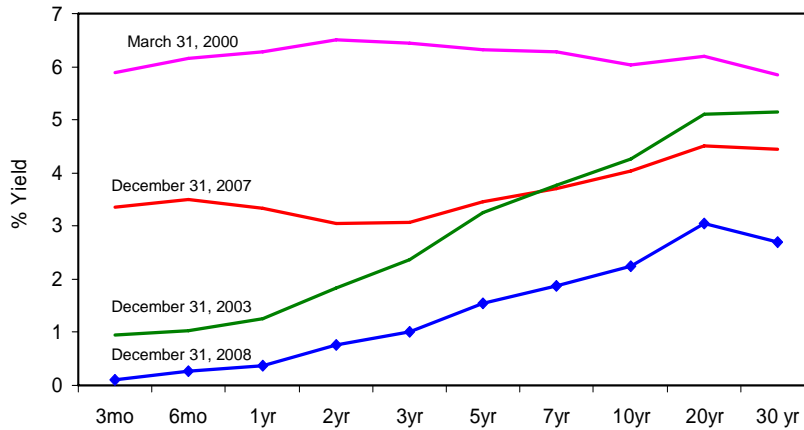
### Effective Federal Funds Rate



Source: Board of Governors of the Federal Reserve System  
Shaded areas indicate U.S. recessions as determined by the National Bureau of Economic Research

While the federal funds rate is the rate used to regulate the supply of money in the U.S. economy and level of lending activity, fixed income market-watchers also pay close attention to yield curves, the graph of actual interest rates and maturities of similar instruments, such as the U.S. Treasury yield curve shown on the next page. It is important to monitor the shape of the yield curve at different points in time. Under normal conditions, a yield curve slopes upward, with short-term securities having a lower yield than long-term securities. The curve on December 31, 2003 had a steep upward slope. Curve-watchers scrutinize interest rates and the resulting shape of the yield curve to see whether a curve has even slightly inverted, as it was on March 31, 2000. The yield curve inverts when the yield on a short-term security is higher than the yield on a long-term bond. During periods of inverted yield curves, investors are not compensated for taking the additional risk of investing in longer term bonds. The 2008 decreases in the federal funds rate impacted the yield curve in all maturities, but most dramatically for short rates. The 3-month Treasury bill yield decreased by 306 basis points, from 3.14% on December 31, 2007 to 0.08% on December 31, 2008. The 10-year bond yield decreased by 186 basis points over the same period, from 4.07% on December 31, 2007 to 2.21% on December 31, 2008.

## U.S. Treasury Yield Curve

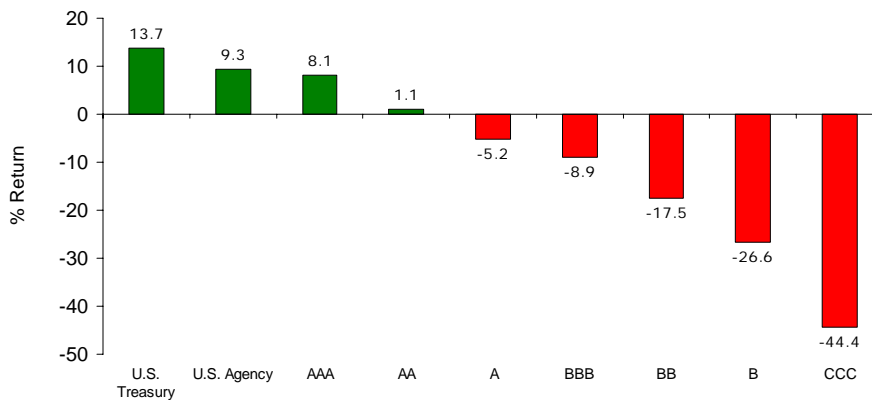


Source: Federal Reserve, statistical release

## Credit Quality and Spreads

Credit ratings are given to bonds based on Standard & Poor's and Moody's analyses of the ability of the corporation to pay interest and repay principal on schedule to bondholders. As reflected in the graph below, credit markets changed dramatically in 2008. Risk was re-priced and there was a flight to quality. U.S. Treasury bonds provided investors with safety and liquidity and had the highest return at 13.7%. Investors shunned CCC corporate bonds, creating illiquidity and pricing issues as investors required higher yields to purchase lower quality bonds, if they would purchase them at all.

## Returns Ranked by Credit Quality 2008

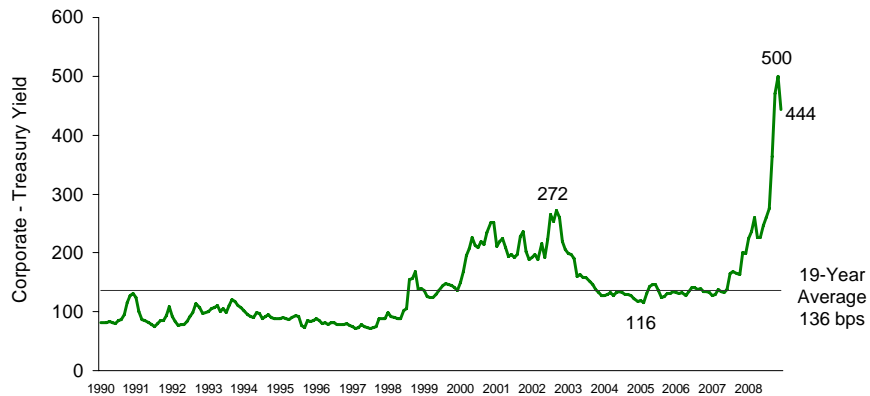


Source: Barclays Capital; Dodge & Cox

The U.S. Treasury bond is typically considered the highest quality long-term investment with the greatest liquidity and no default risk. As such, it is the benchmark security used by investors to price all other long term bonds. The spread for investment grade corporate bonds is a risk premium, or additional yield that investors require for any bond that is not a U.S. Treasury bond. The spread is calculated in basis points, with 1% equal to 100 basis points. As an example, if a corporate bond has a yield of 6.71% and the benchmark 10-year U.S. Treasury has a yield of 4.71%, the spread would be 200 basis points.

As shown on the graph below, from 1990 through 2008 the average spread, or risk premium required for an investment grade corporate bond, was 136 basis points. Prior to 2008, the average was distorted by the events of 1998 through 2002, beginning with the collapse of Long-Term Capital Management and Russian debt default in August 1998. In 2008 rating downgrades, lack of confidence in the rating agencies, weak corporate earnings, accounting and pricing concerns all impacted corporate bonds. Market liquidity evaporated and investors demanded higher yields for anything with even the remotest potential for default risk. Before a slight decrease in December 2008 to 444 basis points, the yield spread on investment grade bonds compared to a 10-year U.S. Treasury was 500 basis points.

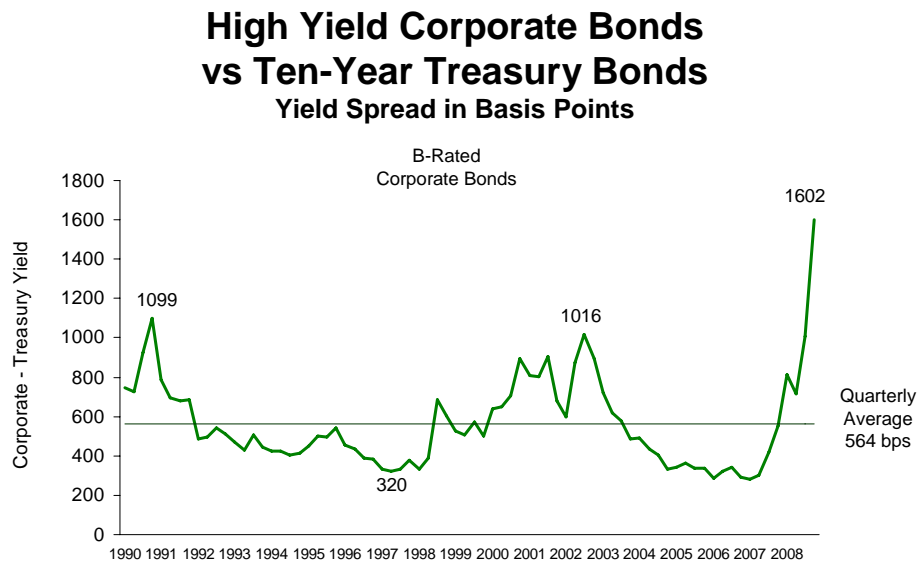
### Investment Grade Corporate Bonds vs Ten-Year Treasury Bonds Yield Spread in Basis Points



Source: Dodge & Cox; Citigroup

Based on investment grade bonds with maturities greater than ten years

As shown on the graph below, high yield bond spreads to U.S. Treasuries repeated the pattern of investment grade corporate bonds to Treasuries, with spreads tripling in the second half of 2008, to close the year at a historic high of 1602.

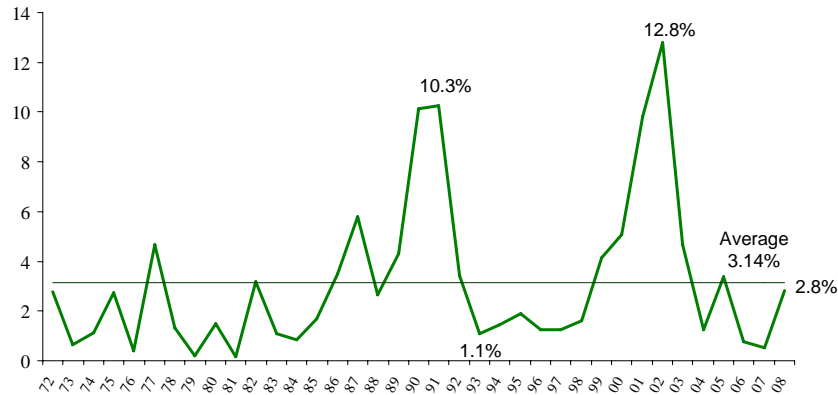


Source: Oaktree Capital; Citigroup

## Default Rates

As shown in the graph on the next page, default rates for corporate bonds last peaked at 12.8% in 2002, when the investment grade corporate bonds of WorldCom and other highly leveraged companies fell to below investment grade and defaulted in a matter of days. The default rate for U.S. dollar-denominated bonds is the par value of defaulted securities as a percentage of the par value of outstanding issues. Default rates increased from 1.2% in 2004 to 3.4% for 2005, with many high yield and distressed debt investors expecting to see a further increase in defaults in 2006. This did not occur. A record number of mergers and acquisitions in 2006 and 2007 required debt financing which some banks provided at favorable rates to companies with increased potential for financial distress. Despite this confirmed decline in underwriting standards, defaults for 2007 remained low although they had started to increase in 2008. Distressed debt investors believe that based on the level of debt outstanding and expected levels of bankruptcies, the default rate in 2009 could exceed the 12.8% experienced in 2002.

## Historical Default Rates 1972 through 2008\*



Source: Oaktree Capital, Citigroup, and JP Morgan  
 \* The 12/31/08 default rate provided is an Oaktree estimate.

### Alternative Investments

The Investment Committee spent time at three meetings in 2007 analyzing the liquidity requirements of the Balanced Investment Portfolio under diverse economic and market conditions. The purpose of the study was to assist in the refinement of asset allocation ranges for alternative investments. The allocation had been up to 10% of the Portfolio in alternative investments, with no distinction made between illiquid limited partnerships and alternative investments in marketable securities. The Committee approved an allocation of up to 10% in illiquid limited partnerships, including private equity, venture capital and distressed debt. The 10% includes market value plus any committed capital not yet invested. Liquid, marketable alternatives, including Real Estate Investment Trusts (REITs) and real return strategies, can be up to 5% of the Portfolio.

As shown on the table on the next page, recent performance of limited partnerships has strongly favored private equity investment, both U.S. and international. Recent performance of distressed debt has been disappointing, reflecting the write down of asset values. Venture capital returns reflect the fact that the venture capital partnerships are not fully invested. The Board of Pensions began investing in alternatives in 1998, so the ten year performance data includes only one investment.

The investments in real return strategies were initiated in 2005 to provide protection under conditions of increasing inflation. Inflation has not been a problem and those strategies have reduced portfolio performance over the last three years.

**ALTERNATIVE INVESTMENT PERFORMANCE HIGHLIGHTS**  
**PERIODS ENDED DECEMBER 31, 2008**

	<u>Annualized Rate of Return</u>				
	<u>1 Year</u>	<u>2 Years</u>	<u>3 Years</u>	<u>5 Years</u>	<u>10 Years</u>
<u>Private Partnerships:</u>					
Private Equity	(4.3)%	15.1%	21.6%	20.8%	18.1%
Distressed Debt	(10.4)	(2.4)	1.8	3.9	n/a
Venture Capital	(3.0)	2.1	1.5	0.5	n/a
<b>Total Private Partnerships</b>	<b>(6.6)</b>	<b>7.9</b>	<b>13.1</b>	<b>13.4</b>	<b>16.2</b>
Russell 3000 + 5% Annually	(34.2)	(14.9)	(4.3)	2.6	3.8
<u>Inflation / Real Return:</u>					
Real Return	(27.6)	(11.2)	(6.2)	n/a	n/a
REITs	(47.0)	(33.6)	n/a	n/a	n/a
<b>Total Inflation / Real Return</b>	<b>(34.7)</b>	<b>(21.6)</b>	<b>(12.7)</b>	<b>n/a</b>	<b>n/a</b>
CPI + 5% Annually	5.1	7.1	7.2	7.7	7.5
<b>Total Alternatives</b>	<b>(16.7)</b>	<b>(3.2)</b>	<b>3.4</b>	<b>6.9</b>	<b>10.5</b>

## Portfolio Accounting

We measure the total return on the Balanced Investment Portfolio using the actual market value of assets held on January 1, 2008, and the actual market value of assets held on December 31, 2008. The beginning asset value is increased by interest income and dividends and decreased by fees and benefits paid during the year. During 2008 the Portfolio received \$210 million in interest income and dividends and paid \$256 million in benefits in excess of dues. The Portfolio had net realized losses of \$191 million on securities sold during 2008. The Portfolio had net unrealized losses of \$2,183 million due to a decline in the market value of securities still held in the Portfolio on December 31, 2008.

**MARKET VALUE RECONCILIATION**  
**BOARD OF PENSIONS BALANCED INVESTMENT PORTFOLIO**

	<u>\$Millions</u>
Market Value on January 1, 2008	\$7,824
Net Income	210
Net Realized Gain/(Loss)	(191)
Net Unrealized Gain/(Loss)	(2,183)
Cash Flows into Portfolio	4
Benefit Payments in Excess of Dues	(256)
Investment and Custody Fees	<u>(21)</u>
<b>Market Value on December 31, 2008</b>	<b>\$5,387</b>

## Plan and Program Participation

The assets of the Board of Pensions Balanced Investment Portfolio are unitized so that each participating plan and program owns units in the portfolio rather than individual securities. This reduces the investment and custodial fees for all plans and programs. The valuation of units is done monthly by BNY Mellon, custodian for all assets, using an accounting process similar to that used to develop the net asset value of a mutual fund. Plans, with the exception of the Medical Plan Long-Term Reserve and Medical Plan Contingency Reserve own only units of the Portfolio. These plans and programs have the same asset allocation and investment performance as the Portfolio, dependent upon the time the plan or program adopted a 100% allocation to the Portfolio.

The Medical Reserves own units of both the Board of Pensions Balanced Investment Portfolio and the Board of Pensions Fixed Income Portfolio. The Fixed Income Portfolio, valued at \$32 million on December 31, 2008, can be used by plans and programs with differing investment horizons, enabling us to customize their long-term asset allocation. It is currently used only by the two Medical Reserves.

The table below shows the market values of plans and programs participating in the Board of Pensions Balanced Investment Portfolio and the Board of Pensions Fixed Income Portfolio at BNY Mellon.

### PLAN AND PROGRAM PARTICIPATION December 31, 2008

	<u>\$Millions</u>	<u>% of BOP Balanced Investment Portfolio</u>
<b>Plan and Program Participation</b>		
<b>Board of Pensions Balanced Investment Portfolio</b>		
Pension Plan	\$4,857	90.17%
Death and Disability Plan	426	7.91
Supplemental Death Benefit Plan	14	0.26
Medical Plan Long-Term Reserve	17	0.32
Medical Plan Contingency Reserve	5	0.09
Endowment Fund	13	0.24
Benefit Supplement Fund	21	0.40
Retirement Housing Fund	11	0.21
General Assistance Fund	15	0.29
Chaplains Deposit Fund	2	0.04
Restricted Gifts Fund	4	<u>0.08</u>
<b>Board of Pensions Balanced Investment Portfolio</b>	<b>\$5,387</b>	<b>100.00%</b>
<b>Board of Pensions Fixed Income Portfolio</b>	<b>32</b>	
<b>Total Investments at BNY Mellon</b>	<b>\$5,419</b>	

The Medical Plan Long-Term Reserve and Medical Contingency Reserve own units of the Board of Pensions Balanced Investment Portfolio and the Board of Pensions Fixed Income Portfolio. The West Virginia Fund, the GAC Special Cuban Fund and the SR Plan, which each have total assets of less than \$450,000, are not shown on the table.

Note: Due to rounding, percentages may not total 100%.

## Partnerships We Can Be Proud Of

The Board uses multiple investment managers for each asset class in the Board of Pensions Balanced Investment Portfolio. Staff and the Investment Committee evaluate, retain and monitor managers for specific assignments within the total portfolio. The managers are responsible for the selection of individual securities or companies for their portfolios.

**Custodian:** The Bank of New York Mellon Corporation, Pittsburgh, PA

### U.S. Equity

Adage Capital Management, Boston, MA  
AllianceBernstein LP, Chicago, IL  
Arbor Capital Management LLC, Minneapolis, MN  
Ariel Investments LLC, Chicago, IL  
Barclays Global Investors, San Francisco, CA  
Barrow, Hanley, Mewhinney and Strauss, Inc., Dallas, TX  
John W. Bristol & Co., Inc., New York, NY  
Dodge & Cox, San Francisco, CA  
PRIMECAP Management Company, Pasadena, CA  
T. Rowe Price Associates, Inc., Baltimore, MD  
Royce & Associates LLC, New York, NY  
Wasatch Advisors, Salt Lake City, UT

### International Equity

Capital Guardian Trust Company, Los Angeles, CA  
Genesis Investment Management, London, UK  
McKinley Capital Management, Inc., Anchorage, AK  
Marathon Asset Management LLP, London, UK  
Walter Scott & Partners Limited, Edinburgh, UK  
Silchester International Investors Limited, London, UK  
Franklin Templeton Institutional, Fort Lauderdale, FL  
Tweedy, Browne Company LLC, New York, NY

### Fixed Income

Capital Advisors, Lancaster, PA  
Dodge & Cox, San Francisco, CA  
GMO, Boston, MA  
Oaktree Capital Management L.P., Los Angeles, CA  
Pacific Investment Management Company, Newport Beach, CA  
Reams Asset Management Company, Inc., Columbus, IN  
Standish Mellon Asset Management LLC, Pittsburgh, PA  
Western Asset Management Company, Pasadena, CA

### Alternative Investments in Private Equity, Distressed Debt, Venture Capital, Natural Resources/Energy, Real Estate and Real Return Strategies

Capital International Investments, Los Angeles, CA  
The Carlyle Group, Washington, DC  
Cerberus Capital Management LP, New York, NY  
Commonfund Capital, Inc., Wilton, CT  
Kolberg Kravis Roberts & Company, New York, NY  
Madison Dearborn Partners LLC, Chicago, IL  
Oaktree Capital Management, Los Angeles, CA  
Riverstone Holdings LLC, New York, NY  
Silver Lake Partners, Menlo Park, CA  
Templeton Asset Management Ltd., Fort Lauderdale, FL  
Vårde Partners, Inc., Minneapolis, MN  
Warburg Pincus LLC, New York, NY  
Wellington Management Company LLC, Boston, MA  
Whippoorwill Associates, Incorporated, White Plains, NY  
Wind Point Partners, Chicago, IL  
Yorktown Partners LLC, New York, NY

## Commentary and Outlook for 2009

In recent years we have noted that we have several missions, and that risk management is as integral a part of our stewardship as good portfolio management. We stressed that we never invested in credit default swaps, subprime loans or complex derivatives. We prided ourselves on a diversified portfolio. However, when global markets collapsed in 2008, our well diversified portfolio of global stocks and bonds lost a significant portion of its market value. As large as our portfolio was, we were a tiny dinghy next to the Titanic when it went down. We capsized in its wake and went down as well.

- We believe 2009 will be a challenging year for investors. The U.S. economy is in a recession. It will take several years for the housing industry to rebound and the banking sector to regain its prior strength. Forecasting stock market returns in 2009 is foolhardy but a range of negative 15% to positive 5% is appropriate for global stock portfolios.
- We expect the return on corporate bonds may be more attractive than the return on stocks in 2009, as fixed income markets stabilize and credit spreads narrow. We will delay rebalancing into stocks until credit spreads narrow and there is greater liquidity in our fixed income portfolios.
- While deflation appears to be more of an issue than inflation in 2009, the Investment Committee and staff will continue to evaluate inflation and real return strategies that could help to maintain the purchasing power of our retirees in periods of inflation and stagflation.
- We will use short-term market outperformance or volatility in individual asset classes to maintain cash to pay benefits. Benefit payments will require cash in excess of dues of more than \$250 million in 2009.
- We will allocate significant time in Investment Committee meetings in 2009 to review lessons learned in 2008 and how we can better manage the Board of Pensions Balanced Investment Portfolio.
- We are long-term investors. We have a long-term strategic asset allocation based on our liabilities or the promised benefits to our Plan members. We will not increase portfolio risk by using short-term trading strategies to improve investment performance.
- We are socially responsible investors and partners with the denomination's Committee on Mission Responsibility Through Investment (MRTI) to assist in the mission of the denomination on issues of corporate governance and social responsibility.
- We will faithfully pursue the goals of our assigned mission, recognizing the needs of those we serve in the Presbyterian Church (U.S.A.).

January 28, 2009

Judy Freyer

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The 2008 **Investment Review** was prepared by the Investment Team of the Board of Pensions of the Presbyterian Church (U.S.A.)

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