

2009 MIDYEAR INVESTMENT REVIEW THE BOARD OF PENSIONS BALANCED INVESTMENT PORTFOLIO

Honey, I Shrank the Economy

If you turn on the TV, read a newspaper, go out to a restaurant, see “For Sale” or foreclosure signs in your neighborhood, shop in empty malls or pass shuttered factories, you know how severe the recession is in your little corner of the planet. I can depress you with unending statistics on unemployment, underemployment, railcar usage, consumer sentiment, and factory utilization, but you know the economy is not doing well and whether the Consumer Sentiment Index is 50 or 70, the economy is still in a recession and those green shoots of growth some economists think they see are probably plastic plants from an old aquarium.

Some of the economic experts tell us that we have to settle for a “New Normal”, which seems to be shorthand for less money, less stuff, a lower level of spending and a higher level of savings. If it was not so painful to get to this new normal, it might not be all bad. We all can live better with fewer credit cards, no subprime debt and no alphabet soup of complex derivatives securities that we wrote about in our 2007 Midyear Investment Review.

Twenty years ago, “Honey, I Shrank the Kids” was a popular summer movie. The father of the family invented a machine that could shrink an object, including kids and dogs, to 1% of the original size. Why you would want to create an army of Lilliputian people and animals seems a valid question, but this was a family comedy. The kids were saved using Cheerios as life rafts and the machine successfully zapped them all back to their normal sizes. A Disney magic happy ending.

While the total U.S. economy has not shrunk to 1% of its former size, it might well appear the case to foreclosed homeowners and the unemployed. Our happy economic ending may be a bit rockier and take years longer than we would like. There are no Cheerio life rafts for us and unfortunately President Obama does not have that magic machine to re-size our economy to the old normal or even the new normal.

Investment Overview

Investment performance in the first half of 2009 can be divided into two parts. The downdraft of 2008 continued with a vengeance from January 1 through March 9, 2009. Despite the continuation of a global recession, markets roared back to life on March 10, with emerging market stocks taking the lead.

	<u>Jan 1-March 9</u>	<u>March 10-June 30</u>	<u>Jan 1-June 30, 2009</u>
MSCI Emerging Markets	(14.2)%	58.4%	36.0%
MSCI EAFE Index	(26.0)	45.9	8.0
S&P 500 Index	(24.6)	36.9	3.2
Russell 2000 Index	(31.1)	48.9	2.6

(All indices include dividends)

Virtually every asset class with the worst performance in 2008, including high yield bonds, provided stellar performance after March 9. Markets turned very quickly and if you were in cash, you missed a spectacular rally.

Before we review in detail the investment performance for the Board of Pensions Balanced Investment Portfolio, let's spend a few moments on two related concepts of portfolio construction that failed to work as academics and practitioners expected. One concept is correlation and the other is portfolio diversification. We all know the meaning and importance of portfolio diversification. Simply stated, portfolio diversification means you don't put all of your eggs in one basket. You need stocks for long-term growth, bonds for income, and cash for rainy day liquidity. International stocks are important for a portfolio since different economies grow and slow at different rates and some of the best global companies are based outside the U.S.

Historical data for periods prior to 2008 showed that investment performance for major asset classes usually moved in different directions, so that in years the U.S. stock market lagged, Asian emerging markets outperformed, exhibiting a low correlation with the return of the U.S. market. You may have heard a lot over the past year about correlation. Correlation is a statistical measure of how things move together. A correlation of 1.00 means two things move completely in lock step. A negative correlation means that two things move completely opposite each other, and a correlation of zero means the two things have no statistical relationship at all.

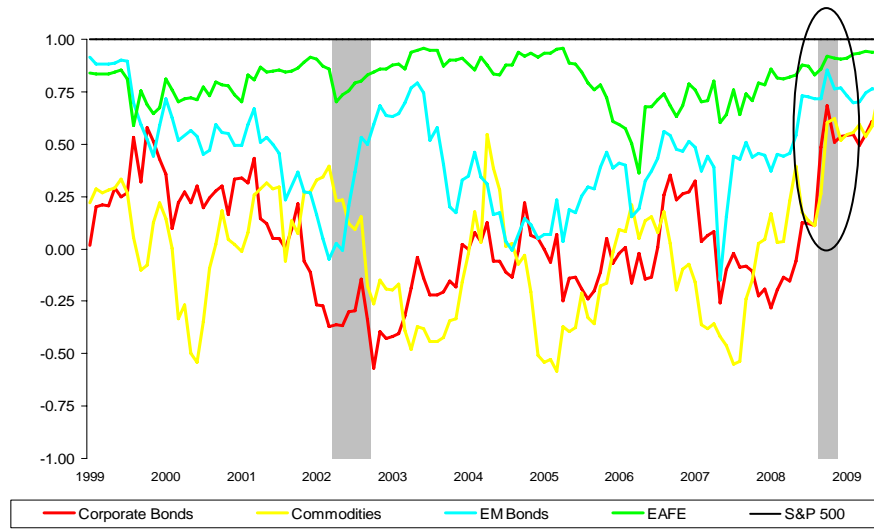
On the graph on the next page, we show a ten year history of rolling 12 month correlations of the S&P 500 Stock Index of U.S. stocks with several asset classes that are traditionally thought to increase portfolio diversification. The lines on the graph are the asset class correlations, not the asset class investment returns. Starting at the top of the graph, the black horizontal line at 1.00 is the S&P 500 itself. The correlation is 1.00, as the correlation of anything with itself is always 1.00. The green line is the Europe, Australia and Far East Index (EAFE) of stocks in developed international markets. It makes sense that this line is generally the closest to the S&P 500 Index line, as global stocks tend to be fairly closely correlated. The blue line is emerging market bonds, the yellow line is commodities, and the red line is investment grade corporate bonds.

There are two shaded periods on the chart. The first is from April 2002 to September 2002, and the second is from September 2008 to November 2008. During each of the two shaded periods, the broad U.S. stock market declined by about 30%. During 2002 market decline, corporate bonds (the red line) and commodities (the yellow line) performed well. Since they were negatively correlated with stocks in this period and went up when stocks went down, they would have provided excellent diversification in a portfolio. Emerging market bonds are represented by the blue line. They became more correlated with equities over time, but the correlation only reached about 0.50. Notice the correlation between U.S. and international stocks (the green line). These asset classes became increasingly correlated over the last decade as stock markets became more global in scope. However, the correlation of U.S. and international stocks actually fell at the start of the 2002 decline in global markets before creeping back up to recent levels.

The 2008 market decline circled on the graph is noticeably different, as all assets on the graph became extremely correlated. Corporate bonds and commodities (red and yellow) reached correlations of more than 0.60 with equities, emerging market bonds (blue) reached 0.85, and international equities (green) topped 0.90. Notable, as well, is how sharply and quickly these lines moved up from modest levels just months earlier in 2008.

This meant that in the fourth quarter of 2008, when asset class correlations converged, a supposedly well diversified portfolio of stocks, bonds, and commodities provided no downside protection and returns went in one direction. Down. While correlations have stabilized in the first half of 2009, they remain at historically high levels.

Rolling 12 Month Correlations with the S&P 500

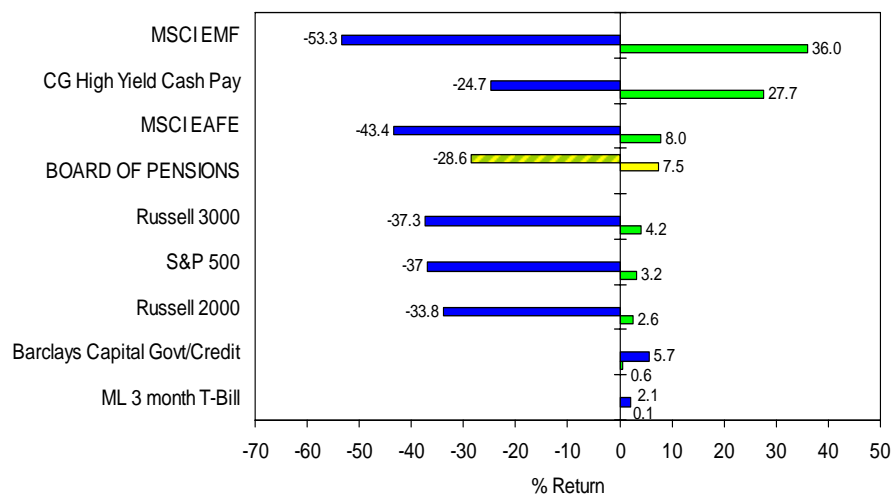


Source: eVestment Alliance

The Board of Pensions Balanced Investment Portfolio

The Board of Pensions Balanced Investment Portfolio had a 7.5% return for the six months ended June 30, 2009. The two worst asset classes in 2008, emerging market stocks and high yield bonds provided the best returns in the first half of 2009. Emerging market stocks provided the best return of 36.0%, with high yield bonds returning 27.7%. Investors maintaining a high cash allocation had a 0.1% return from U.S. Treasury Bills, the safe haven in 2008. International stocks provided U.S. investors with a higher return than the S&P 500 Stock Index, primarily due to the continued weakness of the U.S. dollar.

Returns of Market Indices and
Board of Pensions Balanced Investment Portfolio
Year to Date June 30, 2009 vs. 2008



Sources: BNY Mellon, MSCI (net)

Legend: YTD June 09 (Green), 2008 (Blue), BOP YTD June 09 (Yellow), BOP 2008 (Light Blue)

Review of the Board of Pensions Balanced Investment Portfolio

The Board of Pensions Balanced Investment Portfolio returns net of fees and the asset allocation on June 30, 2009, were as follows:

	YTD 2009	Asset Allocation	
	Return	\$ Millions	Percent
U.S. Equity	8.1%	\$2,115	37.4%
International Equity	10.0	972	17.2
Fixed Income	10.1	2,038	36.1
Alternatives:			
Private LPs	-9.9	421	7.5
Inflation/Real Return	5.7	101	1.8
Total	7.5%	\$5,647	100.0%

The Balanced Investment Portfolio return of 7.5% for the six months ended June 30, 2009 exceeded the asset mix policy benchmark return of 5.1%, while the twelve month return of -17.6% lagged the -16.5% return of the benchmark. The Balanced Portfolio underperformed the asset mix policy benchmark for three years but outperformed for the five and ten years ended June 30, 2009. Inflation as measured by the Consumer Price Index was -1.4% for the one year ended June 30, 2009. The Balanced Investment Portfolio underperformed the absolute benchmark of the CPI plus 5% annually in all periods ended June 30, 2009.

PERFORMANCE HIGHLIGHTS
BOARD OF PENSIONS BALANCED INVESTMENT PORTFOLIO
PERIODS ENDED JUNE 30, 2009

	YTD	Annualized Rate of Return				
		1 Year	2 Years	3 Years	5 Years	10 Years
BOP U.S. EQUITY	8.1	-25.0	-19.5	-8.0	-1.3	-0.1
Russell 3000 Index	4.2	-26.6	-19.9	-8.3	-1.8	-1.5
BOP INTERNATIONAL EQUITY	10.0	-27.4	-17.6	-4.2	5.5	4.1
MSCI All Country World Index ex US	14.4	-30.5	-19.3	-5.3	5.0	2.9
BOP FIXED INCOME	10.1	1.7	2.8	4.2	4.1	5.4
Barclays Capital Gov/Credit Index	0.6	5.3	6.2	6.2	4.8	5.9
BOP GLOBAL BALANCED	6.8	-21.3	-12.5	-3.6	1.7	3.1
World Balanced Benchmark*	7.0	-18.3	-10.8	-2.4	2.4	1.9
BOP PRIVATE PARTNERSHIPS	-9.9	-16.0	-2.0	6.1	9.7	15.3
Russell 3000 + 500 basis points	6.6	-23.0	-16.1	-4.0	2.8	3.2
BOP INFLATION / REAL RETURN	5.7	-29.2	-18.8	-10.8	--	--
Consumer Price Index + 500 basis points	--	3.6	6.7	7.1	7.6	7.6
BOP BALANCED PORTFOLIO	7.5	-17.6	-11.8	-2.9	2.1	2.9
BOP ABSOLUTE BENCHMARK						
Consumer Price Index + 500 basis points	--	3.6	6.7	7.1	7.6	7.6
BOP RELATIVE BENCHMARK						
Asset Mix Policy Benchmark**	5.1	-16.5	-10.8	-2.4	2.0	2.3

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 Bond Index. Previously, the World Balanced Benchmark was calculated using 65% MSCI World Index 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 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

The first half of 2009 provided investors with strong performance from most actively managed public market investment strategies. The U.S. equity component of the Balanced Investment Portfolio exceeded the Russell 3000 benchmark year to date and for the one, three, five and ten years ended June 30, 2009. Later in this Investment Review we will provide some insights into the structure of the U.S. equity component of the Balanced Portfolio.

The international equity component lagged the benchmark of the MSCI All Country World Index ex US year-to-date, but exceeded it for the one, three, five and ten years ended June 30, 2009.

The fixed income component exceeded the benchmark of the Barclays Capital Government/Credit Index for the six months ended June 30, 2009 but lagged in all other time periods due to extremely poor performance in 2008.

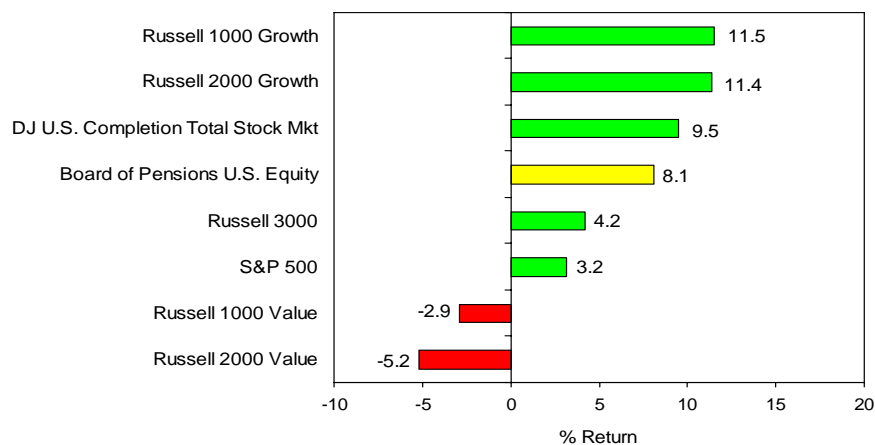
The alternative investment component of the Balanced Investment Portfolio consists of investments in limited partnerships and in inflation protection/real return strategies. Limited partnership investments are primarily U.S. and international private equity, venture capital, energy and distressed debt. The limited partnerships have seven to ten year investment horizons, making performance less meaningful in earlier years when committed dollars have not been fully invested. The benchmark of the Russell 3000 plus 500 basis points annually reflects the return that could have been achieved in the U.S. stock market, plus a premium which reflects the lack of liquidity in limited partnership investments. Reporting of valuations and investment performance for private partnerships is generally lagged by one quarter, with the June 30 data reflective of March 31, 2009 valuations for many partnerships. The private partnership component lagged the benchmark year-to-date but exceeded the benchmark in all other time periods ended June 30, 2009. The real return strategies include U.S. and global REITs or real estate investment trusts, as well as portfolios using Treasury Inflation Protected Securities (TIPS) and commodities. These strategies have been introduced over the past four years and have failed to outperform the benchmark of the CPI plus 5%.

U.S. Equity Performance

The U.S. equity component of the Board of Pensions Balanced Investment Portfolio returned 8.1% for the six months ended June 30, 2009, exceeding the 4.2% return of the Russell 3000 benchmark for the same period. For the twelve months ended June 30, 2009 the U.S. equity component had a -25.0% return, which was better than the -26.6% return of the Russell 3000 benchmark. The U.S. equity component exceeded the Russell 3000 in all periods ended June 30, 2009. The Russell 3000 Index contains stocks of large, medium and small companies and is the most appropriate benchmark for performance comparison.

U.S. Equity Index Returns

Year to Date June 30, 2009



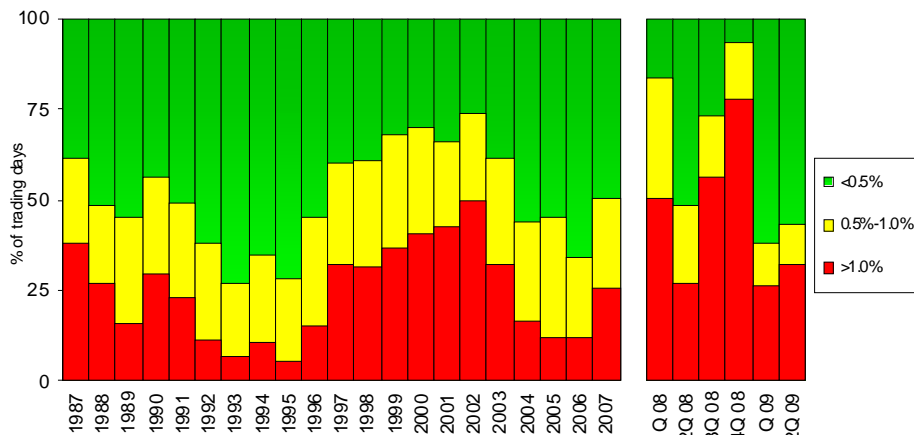
With a significant weighting of companies in information technology, the best performing sector in 2009, the Russell Growth indices had the best performance in the first half of 2009. The Russell Value indices, both smaller companies in the 2000 Value and large companies in the 1000 Value, provided negative returns. Both value indices have large allocations to the financial sector, the sector with the worst return in 2009. The

DJ U.S. Completion Total Stock Market Index, formerly known as the DJ Wilshire 4500 Stock Index or Extended Market Index, is the total U.S. stock market excluding the companies in the S&P 500.

U.S. Market Volatility

In late 2008 the daily volatility of the S&P 500 Index returned to levels not experienced since 2002. The chart below portrays the daily movement of the S&P 500 Index, based upon the change in daily closing price from one trading day to the next. The chart 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. In October 2008, 87% of the trading days had a daily price change greater than one percent. This level of extreme volatility continued in November, when 79% of trading days had a daily price change of greater than one percent and December 2008, when 68% of trading days had a greater than a one percent daily price change. Conditions changed dramatically in 2009. In the first quarter, 26% of trading days had a daily price change greater than one percent. The second quarter of 2009 had an increase to 32% but was less than half of the December 2008 market volatility, as measured by trading days with a daily price change greater than one percent.

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



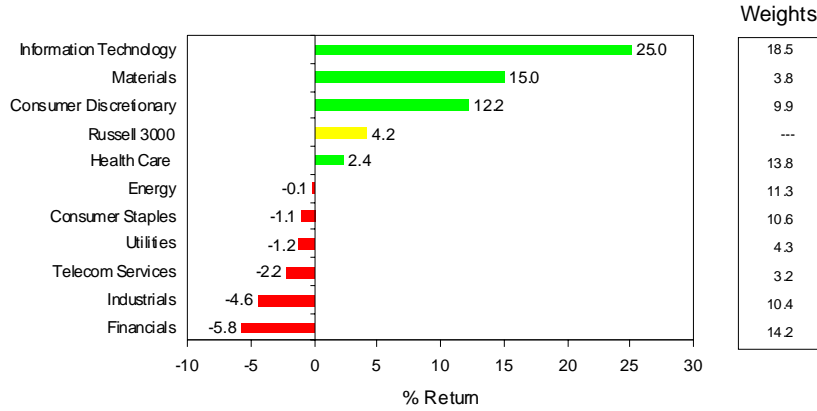
* Daily closing value of S&P 500 as compared to prior trading day's closing value. Does not differentiate between movements up or down. Does not reflect intraday movements.

Sector Performance and Weighting

As shown on the chart on the following page, the performance of the Russell 3000 Index by sector highlights the continued weak performance in 2009 from financials, the second largest sector in the Index, with a 14.2% weighting. Information technology with a weighting of 18.5% of the Index, had the strongest return of 25.0%.

Russell 3000 Index Sector Returns and Weights

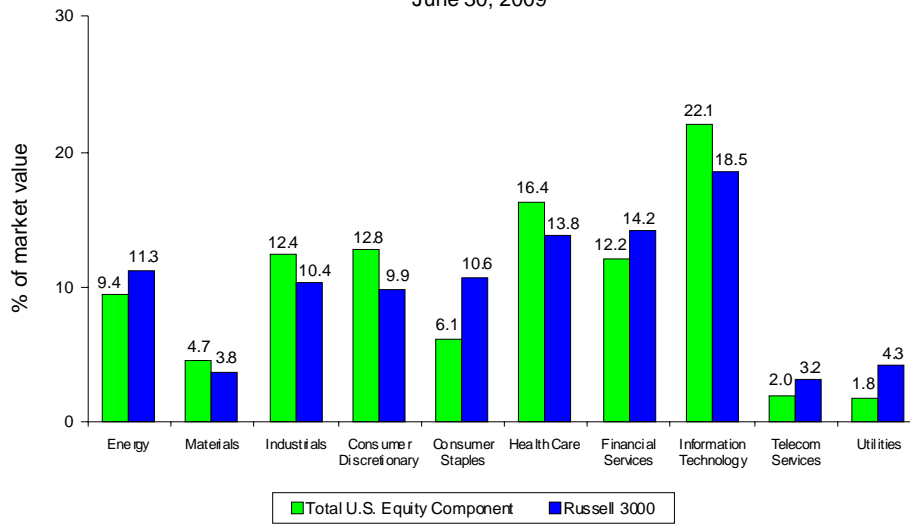
June 30, 2009



Using portfolio holdings based analyses, we can compare the sector weights of the U.S. equity component of the Balanced Investment Portfolio to the Russell 3000 Index sector weights. The Balanced Investment Portfolio has significant over and underweights by sectors. Each sector weight, such as the 22.1% allocation to information technology in the U.S. equity component of the Balanced Investment Portfolio, compared to the 18.5% allocation in the Russell 3000 Index, is the result of active stock selection decisions made on a daily basis by the managers retained by the Investment Committee of the Board. The three best performing sectors in the Russell 3000 were information technology, materials and consumer discretionary and our managers were overweight all three sectors. The three worst performing sectors were financials, industrials and telecom services. Our managers were overweight health care, a large sector which returned 2.4% year-to-date, underperforming the 4.2% return of the Russell 3000.

U.S. Equity Component Characteristics Sector Weights vs. Russell 3000 Index

June 30, 2009



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.

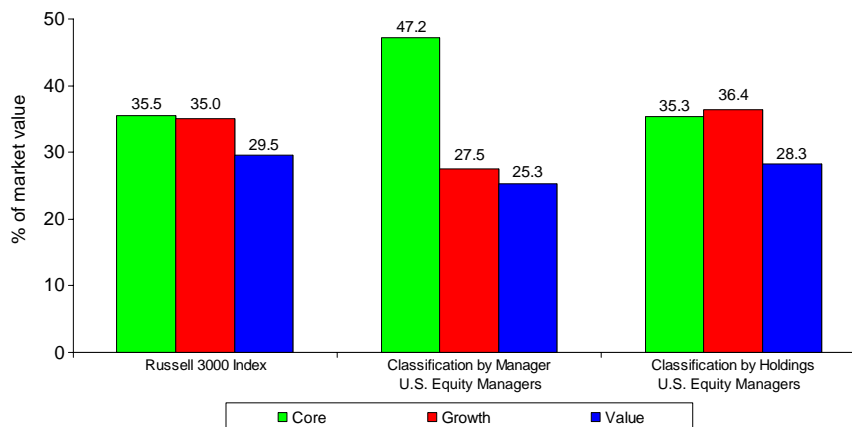
As shown on the graph below, on June 30, 2009, the Russell 3000 Index contained stocks that were classified as core (35.5% of stocks in the index), growth (35.0%) and value (29.5%). The index is rebalanced annually and stocks can move from value to growth and vice versa. In the most recent June 30 rebalancing, Hewlett Packard, the largest holding in the U.S. equity component of the Balanced Investment Portfolio, was reclassified from growth to core. Schlumberger was also moved from growth to core, while Occidental Petroleum skipped the core position and moved directly from growth to value.

A comparison of the structure of the U.S. equity component of the Balanced Investment Portfolio to the Russell 3000 Index by manager classification 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 style, such as core, growth and value, the Portfolio has a 47.2% allocation to core managers, 27.5% allocation to growth managers and a 25.3% allocation to value managers. On the surface, this analysis could lead a portfolio strategist to increase the allocation to value managers and decrease the large allocation to core managers.

A review of the Portfolio using actual stocks presents a different picture, with a decrease in the allocation to core equities and an increase in growth and value stocks. Using this analysis, 35.3% of the Portfolio was invested in core stocks, 36.4% in growth stocks and 28.3% in value stocks.

Growth/Value Characteristics

U.S. Equity Component as of June 30, 2009



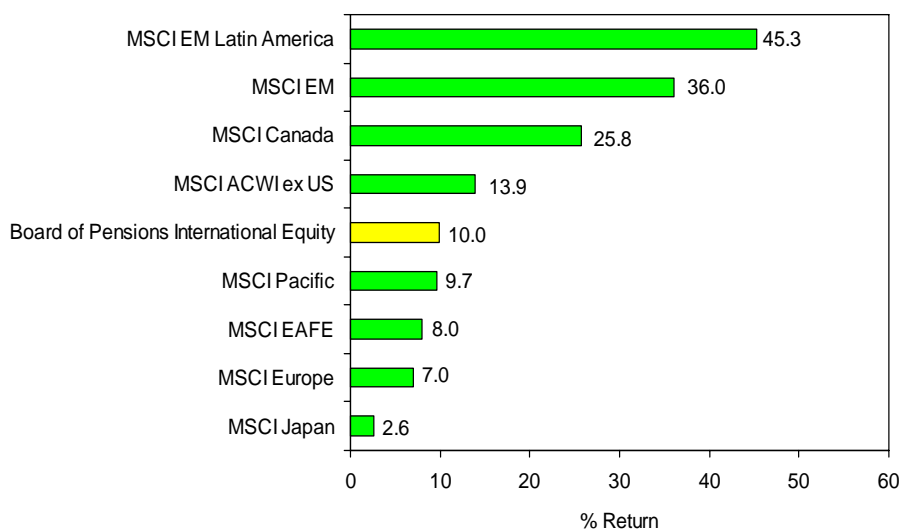
International Equity Performance

The international equity component of the Board of Pensions Balanced Investment Portfolio returned 10.0% year to date, lagging its MSCI All Country World Index ex US benchmark return of 14.4%. For the year ended June 30, 2009, the international equity component returned -27.4%, better than the benchmark return of -30.5%.

A comparison of investment returns of the major international equity indices shows that emerging markets, with a return of 36.0% provided the strong performance in the first half of 2009. Emerging countries in Latin America provided the best performance, with a 45.3% return for the first half of 2009. Developed European markets provided the second worst performance, despite strong returns from financial stocks. The Japanese stock market was the laggard, with a return of 2.6% to U.S. dollar investors.

International Equity Index Returns

Year to Date June 30, 2009



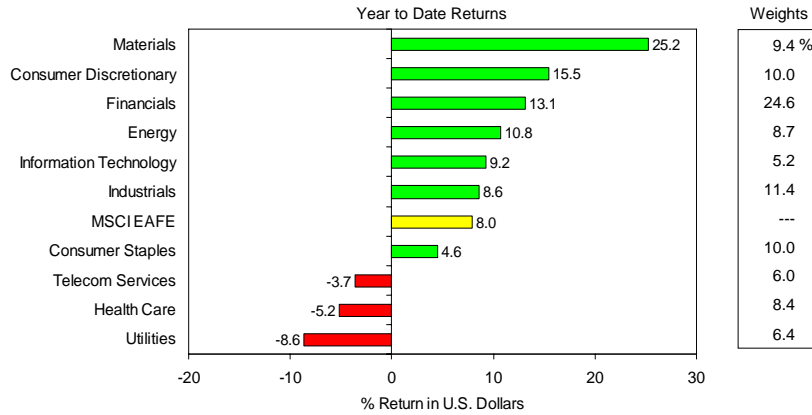
Source: BNY Mellon, MSCI (net)

The performance of the international equity component of the Balanced Investment Portfolio lagged the return of the benchmark index in the first half of 2009, primarily due to a lower dedicated allocation to emerging markets, our selection of active manager strategies and the individual manager decisions on country, sector and companies. The international equity component has an allocation of 18.1% to emerging markets on June 30, 2009, compared to a 20.9% allocation in the MSCI All Country World Index ex US. Several of our managers had an above index allocation to Japan, which had a return of 2.6% due to reduced exports, continued recession and weak yen.

All active managers had an underweight in the financial sector, which proved to negatively impact performance. The financial sector comprises 24.6% of the EAFE Index and returned 13.1%, exceeding the 8.0% return of the Index. Our managers were overweight health care and utilities, two sectors with negative performance in the first half of 2009. Our portfolio had higher quality, more defensive companies during a period when lower quality companies, including financials, provided strong returns. The weakness of the U.S. dollar against most major currencies also added to returns from international equity, with the return in U.S. dollars exceeding returns in local currencies in most markets.

As shown in the chart on the next page, returns for international equities in the MSCI EAFE developed market index followed a different pattern of sector winners and losers than the Russell 3000 Index of U.S. stocks. Materials and consumer discretionary sectors were in the top three best sectors for the Russell 3000 and EAFE. However, as previously noted, financials were a top performer for EAFE and the worst performing sector in the Russell 3000. The only overlap in the bottom three sectors was telecom services.

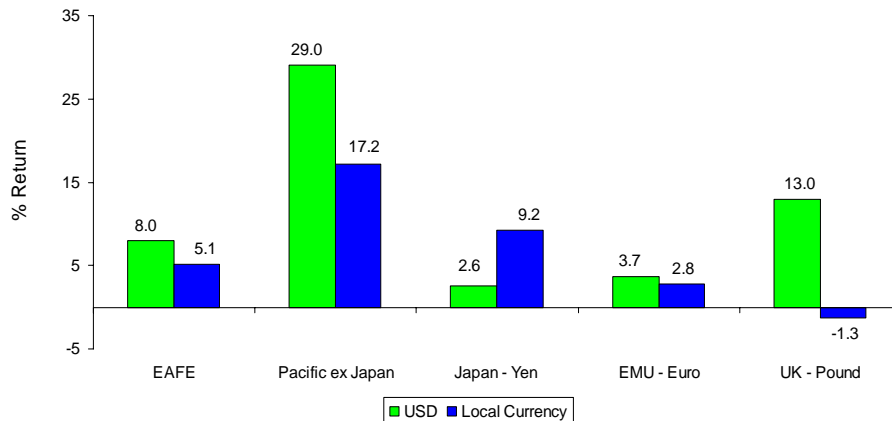
MSCI EAFE Index Sector Returns and Weights June 30, 2009



Source: MSCI (net)

Currency is always a critical component of successful international investing. As shown on the graph below, in the first half of 2009, currency meant the difference between good returns and great returns. U.S. dollar investors in international equities benefitted from the weakness of the U.S. dollar in virtually all stock markets except Japan, where the yen decreased 5.9% against the dollar. Local currency investors in the Japanese stock market experienced a 9.2% return for the six months ended June 30, 2009, while the decreased value of the yen reduced that return to 2.6% for U.S. dollar investors in Japan. United Kingdom local investors had a return of negative 1.3%, but the 12.8% increase in the value of the pound against the dollar meant a 13.0% return for U.S. dollar investors in the U.K. stock market. The superior return for U.S. dollar investors in the Pacific region excluding Japan was primarily due to the strengthening of the Australian and New Zealand dollars, up 14.7% and 11.5%, respectively against the U.S. dollar.

MSCI EAFE Developed Markets U.S. Dollar Returns vs. Local Returns Year to Date June 30, 2009



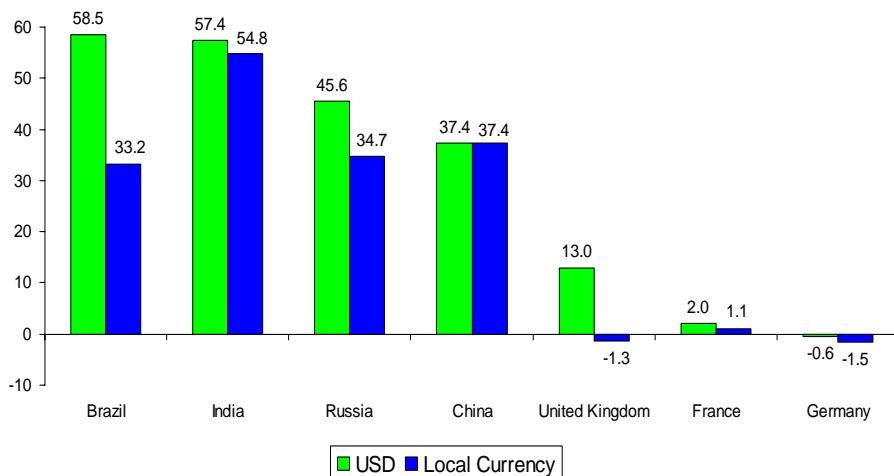
Source: MSCI (net)
EMU: European Monetary Union

The negative performance of emerging markets in 2008 and early 2009 sharply reversed beginning on March 10, 2009. While currency has historically been a smaller component of investment returns in emerging markets, it can play a significant role. The Brazilian real appreciated 18.2% against the U.S. dollar from January 1 to June 30, 2009. This meant the 33.2% investment return for local investors became a 58.5% return for U.S. dollar investors in the same portfolio of Brazilian stocks. Over the same six month period, the euro appreciated 0.4% against the U.S. dollar, providing a slight benefit to investors in the poorly performing markets in Europe, including France and Germany.

MSCI Country Performance

Year to Date June 30, 2009

Sorted by US\$ returns



Source: MSCI (with dividends reinvested, net)

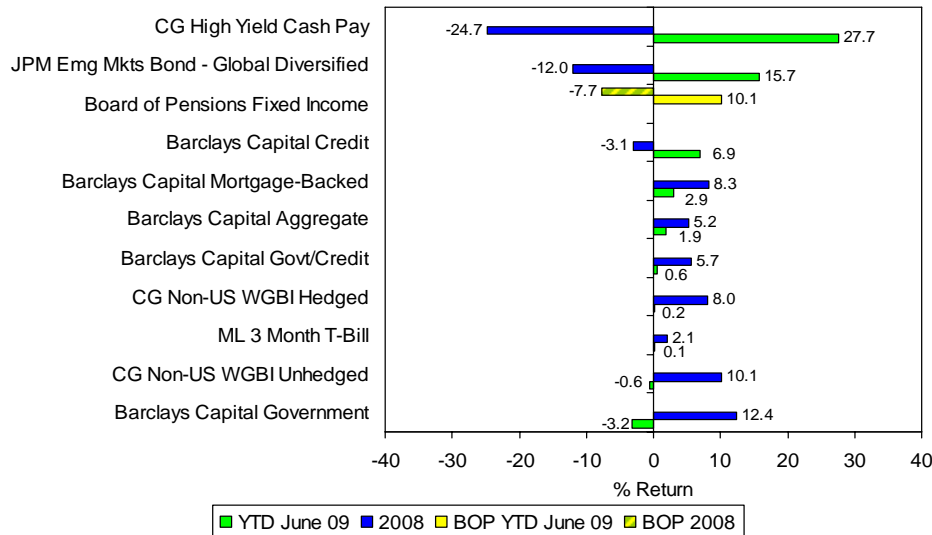
Fixed Income Performance

The fixed income component of the Board of Pensions Balanced Investment Portfolio had a return of 10.1% for the six months ended June 30, 2009, significantly outperforming the 0.6% return of the Barclays Capital Government/Credit Index. The 1.7% return for the twelve months ended June 30, 2009 lagged the 5.3% return of the benchmark index. The fixed income component also failed to meet the benchmark of the Barclays Capital Government/Credit Index for the three, five and ten years ended June 30, 2009. This can be attributed to the extremely challenging markets and poor performance in 2008.

Fixed income 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. As we all remember, in 2008 there were very few strategies other than U.S. Treasuries that worked for active fixed income managers. As shown on the graph below with 2008 and year-to-date 2009 returns, in 2008, when spreads widened and investors tried to shed risky assets, the worst performing strategies were U.S. high yield bonds, emerging market debt and investment grade U.S. corporate bonds. The fixed income component of the Balanced Investment Portfolio was overweight all three sectors and the 2008 fixed income component return of negative 7.7% lagged the positive 5.7% return of the Barclays Capital Government/Credit Index by more than 1300 basis points.

Fixed Income Index Returns

Year to Date June 30, 2009 vs. 2008



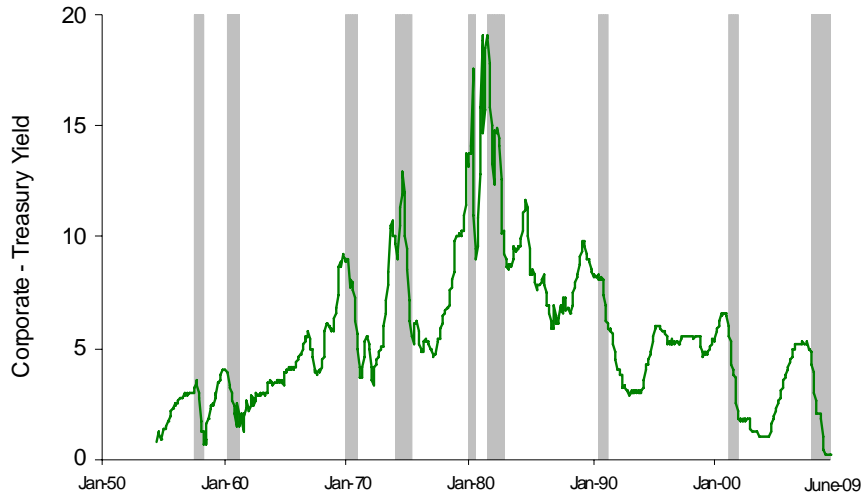
What hurt in 2008 has helped fixed income performance in 2009. The Citigroup High Yield Index, with a return of 27.7% for the six months ended June 30, 2009, provided the strongest performance. This was followed by emerging market bonds, with a 15.7% return. While U.S. Treasury Bills had a return of only 0.1%, that was better than the negative 3.2% return from Barclays Capital (U.S.) Government Index.

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 on the next page provides a long-term history of the federal funds rate. In June 1981 the rate peaked at 19.1% while the May 1958 rate of 0.63% 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%. It remained unchanged on June 30, 2009.

Effective Federal Funds Rate

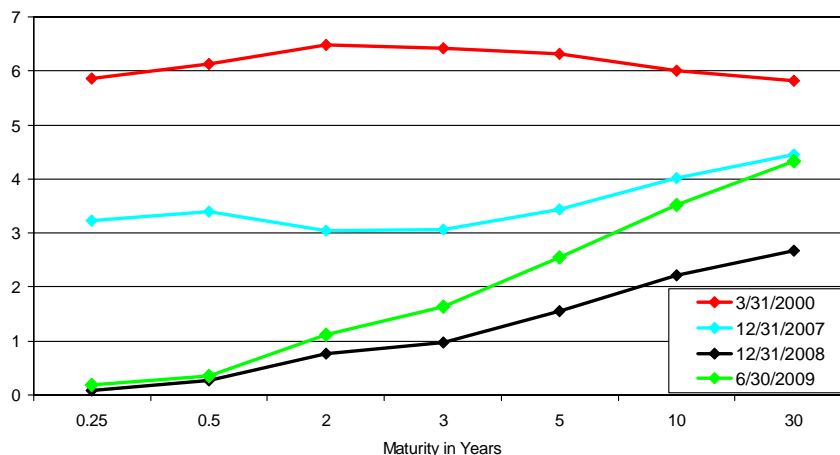


Source: Board of Governors of the Federal Reserve System
Shaded areas indicate U.S. recessions as determined by the National Bureau of Economic Research

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.

The top line on the graph on the next page is the yield curve for U.S. Treasury securities on March 31, 2000. It serves as a reference point for the unprecedented decline in short term interest rates. The 2008 decreases in the federal funds rate impacted the yield curve in all maturities, but most dramatically for short rates. In 2008, the 3-month Treasury bill yield decreased by 316 basis points, from 3.24% on December 31, 2007 to 0.08% on December 31, 2008. A basis point is a unit that is equal to 1/100th of a percentage point. The 10-year bond yield decreased by 181 basis points over the same period, from 4.02% on December 31, 2007 to 2.21% on December 31, 2008. In the first half of 2009, the 3-month Treasury bill yield increased slightly from 0.08% to 0.18% on June 30, 2009. The 10-year bond yield had a more significant increase over the same six month period, increasing 132 basis points from 2.21% on December 31, 2008 to 3.53% on June 30, 2009.

U.S. Treasury Yield Curve Changes



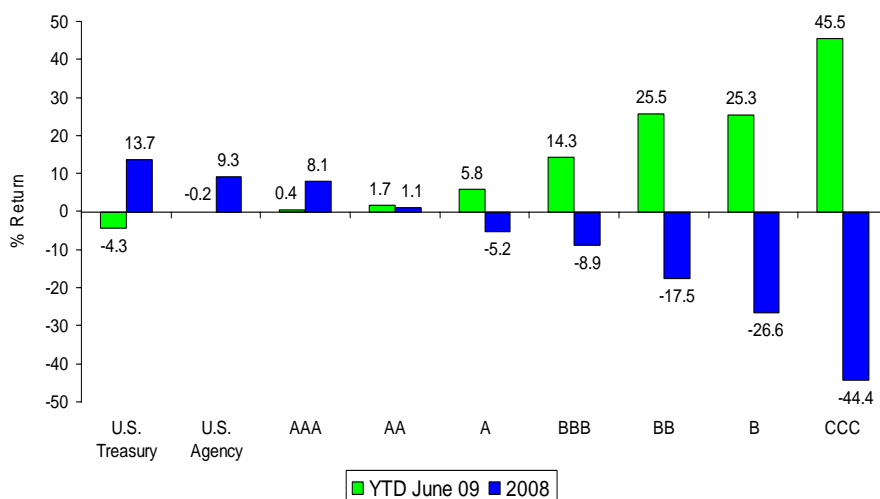
Source: Bloomberg

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 and in the first half of 2009. Risk was re-priced in each period. In 2008 investors fled the credit markets and there was a flight to quality as they tried to shed risky assets at any price. U.S. Treasury bonds provided investors with safety and liquidity and had the highest return at 13.7%. Investors shunned CCC-rated corporate bonds, creating illiquidity and re-pricing issues downward as investors required higher yields to purchase lower quality bonds, if they would purchase them at all.

Returns Ranked by Credit Quality

Year to Date June 30, 2009 vs. 2008



Source: Barclays Capital; Dodge & Cox

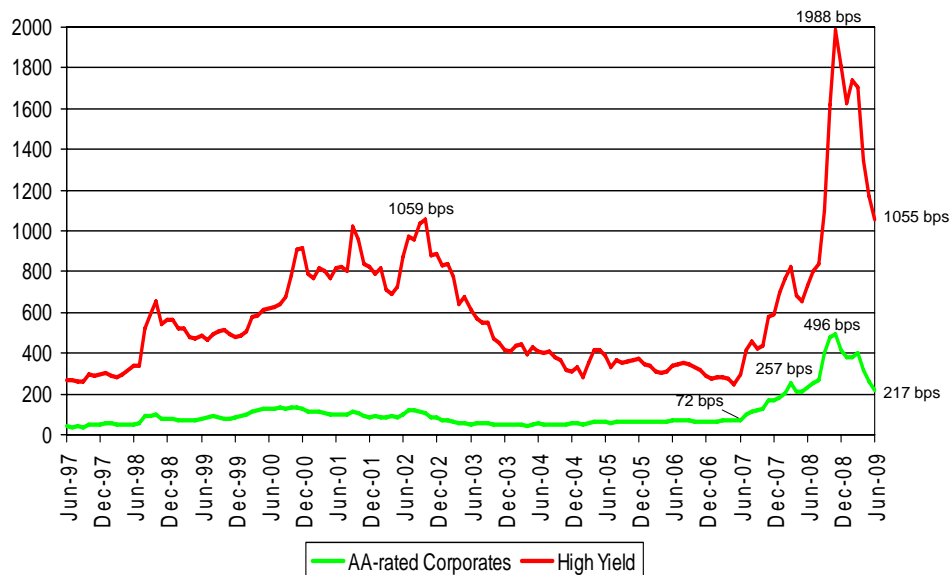
In the first half of 2009 investors decided to re-price risk again and jumped back into risky assets with both feet. Investor appetite for lower quality bonds resulted in a 25.5% return for BB bonds and a staggering 45.5% return on CCC bonds, the lowest quality high yield bonds still paying their contractual interest payments.

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.

The graph below shows the spread to U.S. Treasuries for investment grade corporate bonds and for lower quality non-investment grade high yield bonds. The spread for AA bonds was fairly stable from June 1997 through June 2007, when the issuer of AA corporate bonds would have paid 72 basis points higher than the interest rate on a U.S. Treasury to issue their debt. As the economy weakened in late 2007 and the first half of 2008, issuers had to pay 257 basis points over the Treasury interest rate. The spread or risk premium required by investors to purchase investment grade corporate bonds increased to 496 basis points during the global credit crisis in the fourth quarter of 2008. As credit conditions improved in 2009, the spread decreased to 217 basis points, still much higher than the 72 basis points of June 2007.

The spread on high yield bonds reached 1,059 basis points in 2002. This increased to 1,988 basis points in the global credit crisis in the fourth quarter of 2008. The collapse of Lehman Brothers and AIG impacted the pricing of all corporate bonds. Market liquidity evaporated and investors demanded higher yields for the bond of any company with even the remotest potential for default. Investors liquidated high yield bonds often at any price due to justified concerns over possible corporate bankruptcy and default on the debt. As credit market conditions improved in 2009, the spread was reduced to 1,055 basis points on June 30, 2009. This narrowing of spreads, driven by renewed investor interest in higher risk assets, resulted in the strong performance of high yield bonds in the first six months of 2009.

Corporate Bond Spreads

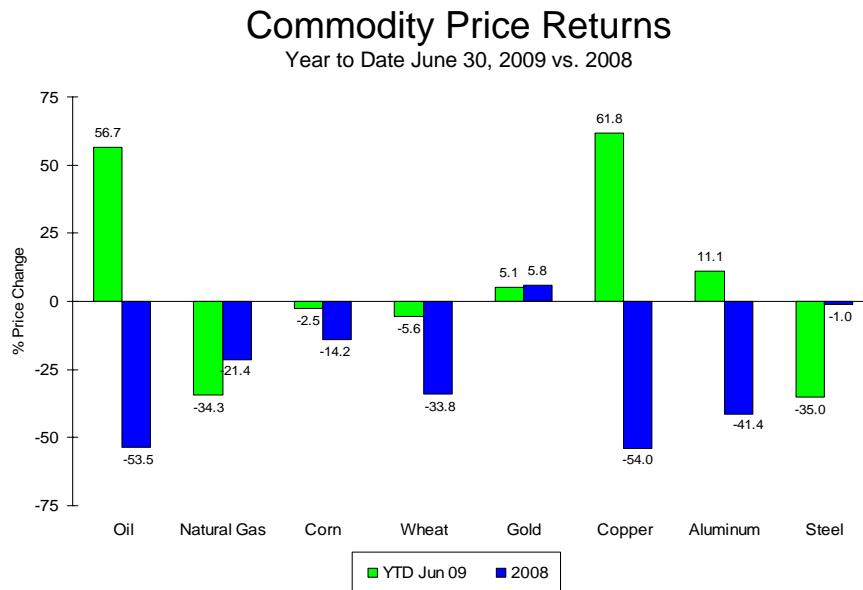


Source: Merrill Lynch indices, Reams Asset Management

Investment Commentary

Most people like to be in control of a situation or at a minimum, at least know what the situation is. The frightening thing for those kids who were shrunk to 1% of their prior sizes was they knew that they had lost control over their environment. When the economy and our investment portfolios shrunk, we all experienced that equally frightening loss of control over our environment. As investors in a rapidly changing global economy, short of hoarding cash and commodities, we can feel we have not only been diminished in size but also in the power to control our own destiny.

Sometimes there really are few if any places to hide. If investors burned by stock and bond losses in 2008 thought commodities might have been a better asset class, 2009 would have proved that to be an incorrect thesis. In prior graphs we showed the significant performance differences in marketable assets like high yield bonds from one year to the next. The graph below shows what has happened over the last 18 months in the pricing of hard assets. The price of gold remained stable but oil and copper prices, whether due to actual usage, speculation or hoarding, experienced huge pricing variations. Can an investor predict the price of a widely used commodity like copper when it declines in price by 54.0% in 2008 and increases 61.8% in the first half of 2009?



Source: Bloomberg

More than two years after we first wrote about problems with CDOs, CLOs, CDS, and SIVs, our financial system is still not finished digging out from the longer-term impact of the alphabet soup of investment opportunities created during the years of low interest rates and easy credit.

Twelve long months ago, as we wrote the 2008 Midyear Investment Review, the most debated question was whether the U.S. economy would experience inflation or deflation. Few among us would have predicted the chain of events that shook our world beginning in September 2008. We had no crystal ball to predict the future then and do not have one today.

We all know that the U.S. economy cannot be re-sized by a magic machine and our soggy Cheerios will not work very well as life rafts. With increased government oversight of the economy, markedly reduced financial leverage and cautious consumers, the U.S. economy will remain fragile. We expect that global investment conditions in the balance of 2009 will continue to be volatile and challenging. We remain vigilant in our oversight of portfolio liquidity and have increased the allocation to the short duration fixed income

portfolio to provide ready liquidity in volatile markets and preserve principal in the event interest rates increase in 2010.

We stated at the beginning of this Investment Review that we would not include the numbing statistics on unemployment and other economic indicators. We did present such an investment review at the [Regional Benefits Consultations](#) in April and May 2009. We will send the slides and text upon request.

We look forward to reporting to you in January 2010 on the 2009 performance of the Board of Pensions Balanced Investment Portfolio. Can we hope that “Light at the End of the Tunnel” will be our title?

July 29, 2009

The **2009 Midyear Investment Review** was prepared by the Investment Team of the Board of Pensions of the Presbyterian Church (U.S.A.).

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Data source, unless otherwise noted, is The Bank of New York Mellon Analytical Services.

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