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Representing:

STATE BOARD OF ADMINISTRATION

The above agencies came to be heard before THE FLORIDA CABINET, Honorable Rick Scott presiding, in the Cabinet Meeting Room, LL-03, The Capitol, Tallahassee, Florida, on Wednesday, March 9, 2011, commencing at approximately 1:08 p.m.

Reported by:

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* * *

I N D E X

STATE BOARD OF ADMINISTRATION
(Presented by ASH WILLIAMS)

P R O C E E D I N G S

GOVERNOR SCOTT: Good afternoon, everybody. Ash, are you ready to begin?

MR. WILLIAMS: I am, sir.

We're going to do several things today. Just by way of introduction, first of all, I wanted to thank the Trustees for the generosity you've shown with your time and that of your professional staff in taking time to prepare for today's meeting, starting with our fiduciary training with outside fiduciary counsel, which everybody was tremendously generous with their time, highly attentive, et cetera.

And per the direction that we received from the Governor's Office, we were very careful to craft our agendas going forward to address the six points that the Groom Law Group identified as the key tests that you as Trustees need to meet to ensure that you've followed your fiduciary duty.

So everything that you are seeing here today is designed around those points, and we have, for lack of a better term, value engineered the agenda so that to the extent we have prior components of the agenda that were standing areas that did not necessarily go directly to those points, rather than allocating our time to those, we simply placed written reports in the book, which no doubt your staffs and you have had an opportunity to look at. We have the principals here for every one of those reports, and you can question them directly at your pleasure.

But to save time, we're going to follow the 80/20 rule and focus 80 percent of our time on the 20 percent of the things that we do that are most important and most germane to your fiduciary responsibility. So that is the premise that has guided everything you will see today.

What I would offer overall is several things. First, I would like to recognize a number of members of our external advisory and oversight bodies who were kind enough to spend time with us today. They're all citizen volunteers, highly talented people with plenty of things to do with their time.

We have John Hill, who is chairman of the IAC; Rob Gidel, who is the incoming chairman of the IAC; Chuck Newman, a new member of the IAC. Yesterday we also had with us for the IAC meeting Martin Garcia, another one of the new members. We have the chairman of the Participant Local Government

Advisory Council, Patsy Heffner, and Roger Wishner, who serves with distinction on that body as well. We also have Bill Sweeney, who is -- there he is -- who is chairman our Audit Committee. These are all terrific people who have done a lot for the Board. They're a tremendous resource for us, and we thank them for being here.

GOVERNOR SCOTT: Thank you very much for coming and for all your service.

MR. WILLIAMS: And as always, as you know, any of you have direct access to them at any time and have an unfettered source of information independent of the staff of the SBA at your disposal.

GOVERNOR SCOTT: Ash, should we do like in the -- I'm sure you've thought about this before, like in a publicly traded company, you sit down without the management, you know, at the end of a meeting for 15 minutes or anything like that. I guess you can't do that anyway with an open record law, sunshine law.

MR. WILLIAMS: Yes. That is actually a very good question. And there are other public funds around the country that have an executive session capability.

GOVERNOR SCOTT: But we don't.

MR. WILLIAMS: And it's not uncommon for audit committees to have those, and compensation committees, of course, in the corporate world.

In the Florida environment, the emphasis has always been that the value of sunshine outweighs the contribution of those other areas. I'll withhold judgment on that.

GOVERNOR SCOTT: But we just can't do it.

MR. WILLIAMS: I guess you could, but you would always have somebody question you, so --

GOVERNOR SCOTT: Okay.

CFO ATWATER: Governor, could I jump in there on that? I think there may very well, though, be a place where in the fiduciary training process -- and I appreciated that and the team that you made available to us. And the conversation that we had was, "Well, just read and listen and make your best judgment on what has been handed to you."

As we went further into that conversation, even those trainers acknowledged that there should be at some point an external set of eyes that speaks directly to us as to our risk management processes. And that independent voice could provide us with a comfort level that everything that was provided to us to read wasn't filtered for a particular purpose, wasn't biased in any way, but that someone could take a look at that process and be able to share with us from time to time, "This is where your risks are greatest, this is the management process. It's solidly in place to catch those, and you all are on the right target." And I would still like, Governor, if there wasn't any real objection to continuing that conversation and seeing if there is at some point a practice that we might put into place that could provide at least me a little bit greater comfort, that we have that.

GOVERNOR SCOTT: I guess the way I would think about it, I would love to see, you know, what we want to accomplish, and then I would like to get your feedback on that and then understand what the cost is. But I think having -- you know, we all want to do a good job. I mean, you want to do a good job, and everybody involved in the SBA does, and I know the three of us want to do a good job. So I would love to hear what would be the purpose, what would be the structure, and what would be the cost, and look at it.

CFO ATWATER: And if there is no objection, Governor, I would love to bring back to the

Trustees a concept that we could consider whether the value of the -- of what could be learned would be worth the cost.

GOVERNOR SCOTT: Okay. Can we do it this way? Give us something and -- do you want us to look at it first, or do you want to go ahead and send it --

CFO ATWATER: I would like to build it in conversation with Ash, and he may be able to say, "Look, we already have those processes and that information in place, so that wouldn't be necessary, but if we were to do something like that, sure, this would be the window and the area where we should aim to accomplish that." And if you wouldn't mind, that along with talking with our external advisory members, what they're seeing and getting access to, and bring that back to us.

GOVERNOR SCOTT: Does that make sense?

MR. WILLIAMS: Absolutely. And I think one of the things to keep in mind is when we have -- and we have a couple of them with us today, Hewitt EnnisKnupp & Associates, the general consultants, and Cambridge Associates, who is particularly helpful in the alternative investment area, particularly hedge funds. They are both named fiduciaries to us, as are all of our outside advisors. And we do have an independent Audit Committee that reports to you. Members are appointed by you. They in turn employ our internal audit staff. Three of our internal auditors are here today, et cetera.

So there are many, many independent checks and balances already, including the IAC. But this is certainly an area where the question of how much is enough is not ever an unreasonable question to ask when it comes to --

CFO ATWATER: Maybe just seeing that, then, seeing all that laid it and access points and the timeliness of those visits, information provided ahead of those visits, frequency.

MR. WILLIAMS: We're already working with your staff on codifying all that. We've done it in a narrative form, and we're getting it now in a scheduled format so that you can basically see an abstract that says, here is the frequency, here's the source, here's the content of various reports, so you can see quite clearly what you have.

But it's a very reasonable line of inquiry.

GOVERNOR SCOTT: Okay. Thank you.

CFO ATWATER: Thank you, Governor.

GOVERNOR SCOTT: Thanks.

MR. WILLIAMS: Okay. I think the other thing that's of interest is, we're at kind of an interesting date today. Today is the 9th of March.

Now, what might be significant about the 9th of March? The answer is, two years ago, the 9th of March marked the bottom of the trough in the U.S. equity market, in the financial crisis. And it might be interesting to note what has happened since that time.

And you probably -- you may not have seen it, because it just came out on the 7th of this month, but in the most recent monthly report we sent around to the Trustees -- this is the most recent official data we have on our portfolio through 31 January 2011. On the Pension Plan, we have a return of 17.48 percent, which is 98 basis points ahead of target. If we roll that number to last night's close, then you see that we're actually up for the fiscal year-to-date 19.31 percent. And the fund balance stood at $127.3 billion at yesterday's close.

Now, if you compare that to 83.3 billion, where we were March 9, 2009, that's a nominal difference of $44 billion, which sounds pretty good. But then you have to say, "But, wait. You actually had -- as they say on late night TV, "But wait, there's more." We've actually had net benefit flows of $8 billion negative because we've paid out more than we've taken in in contributions. So if you add that back in, you have a gain of $52 billion net of the distributions we've made from the bottom of the market, so that's a good thing, and I wanted to share that.

It in no way, I believe, however, it in no way stands in the way of the very appropriate policy initiative of looking at affordability and sustainability of the Florida Retirement System or any components thereof. They're two very different things, and I would not constrain one with the other. But I do want you to know about that.

So with that information -- and part of reason I started with that is to give you a sense of where we've been and where we are, but also to set up the real function of -- I think the most fundamental function of today's meeting other than simply helping get you on the curve on what we're doing and what we can do better, and that is, we did an asset/liability study starting at the tail end of 2009, completed it in the first half of 2010 in the wake of the financial downturn, and from that made some minor -- some adjustments for some incremental evolutions in our investment policy. Those changes were adopted by the prior group of Trustees in June of 2010, and we were incrementally proceeding along that path.

But as you know, if you have changes, and significant changes in assets or liabilities or both, then that set the decisions on investment policy should be revisited and recalibrated to reflect the difference in the environment. So I bring up the change in assets because that's one change that's out there.

The other change that's out there is a high probability of legislative actions on structural changes to the pension plan itself and potentially the benefits within the plan, both of which would have ramifications on the liability side that are, I think, unambiguously positive.

So that's a long way of saying where I suspect we may end up today is to have an understanding of where we are now, that we have some changes -- we want to review with you the work that was done last year so you get a sense of what we did and why. We have the outside folks here who advised us on that effort to answer questions directly and do the presentation.

And then our view is that the environment will almost certainly change a bit more during the coming -- well, the legislative session we're now it. It's no longer coming. And that at the end of the session, with the benefit of what the Legislature has done, we can go back and do a readjustment on the liability side, fine tune the investment policy recommendations, and come back to you in the June meeting when everybody has had a chance to really dig into this information as deeply as they need to to have a personal conviction on the correctness of our course, and we can adopt a strategy.

And our suggestion at the outset would be that we proceed incrementally, prudently, thoughtfully, slowly, in a disciplined manner, as we have been. But that's your judgment. You set the risk envelope, we get that, and that's fine.

So that's the broad outline for today's meeting. And we will have presentations starting out from Hewitt EnnisKnupp covering the performance, absolute and relative, for the Florida Retirement System DB Plan, the DC Plan, Florida PRIME, Fund B, and the CAT Fund. Then we'll have standing reports from the Investment Advisory Council, PLGAC, and the Audit Committee, all of which are statutorily required.

As I mentioned, the SBA staff reports are in the brochure. Rather than take time to go through all those, you've got them. If you have questions, we'll respond to them. Then we'll go directly into the review of the investment policy and talk a little bit more about alternatives and how to think about those in terms of risk, et cetera.

And that will be a more than full day, particularly given what you've already been through. We have made every effort to streamline the four-plus hours that we did in the IAC yesterday by about 50 percent today so we don't to inflict cruel and unusual punishment on you.

So that's where we are, and perhaps we should go ahead then and, unless there are questions, hit Item 1, which is a request for a motion on the minutes of the last meeting.

GOVERNOR SCOTT: All right. Is there a motion on the minutes?

CFO ATWATER: So move.

GOVERNOR SCOTT: Is there a second?

ATTORNEY GENERAL BONDI: Second.

GOVERNOR SCOTT: Moved and seconded. The minutes are approved without objection.

MR. WILLIAMS: Thank you. Let me introduce Mike Sebastian of Hewitt EnnisKnupp, and we will go through the performance reports.

MR. SEBASTIAN: Thanks very much.

GOVERNOR SCOTT: Good morning, or good afternoon. I've said that too much, I guess.

MR. SEBASTIAN: Good afternoon. I'm Mike Sebastian with Hewitt EnnisKnupp, the generalist consultant for the Florida SBA. And what I have here is our standard quarterly performance report on the funds, the major funds overseen by the SBA, which would be the FRS Pension Fund, the DC Plan, Florida PRIME, and the CAT Fund.

I'll start out without the executive summary regarding -- I'm sorry. A summary of the DB Plan's investment performance. What we try and look at on a quarterly basis is, first of all, performance relative to a number of different competitive measures, but also just some general thoughts about the structure of the plan and how well it's managed currently and in recent history.

And I would start out with the first couple of bullet points here talking about performance relative to a number of different competitive measures, one being the performance benchmark, which represents the investment policy of the DB Pension Plan, in other words, the target asset allocation that's appropriate for the risk and return associated with the plan, combined with the asset class representations of each of the investment types that are included in the portfolio, and also a comparison of performance relative to the long-term target, which is inflation plus 5 percent per year, which is intended to be in line with the 7.75 percent actuarial rate of return target. Performance relative to both of those measures has been strong over the short- and long-term time periods.

We also compare performance with peers, other large public pension funds. We believe that peer comparisons need to be taken with a grain of salt to a certain extent, because other plans have different objectives and circumstances. However, it's interesting to know in a public environment how the plan stacks up to others, and in general, the pension fund has been competitive with the returns of peers.

We make a note on --

GOVERNOR SCOTT: So the goal is inflation plus 5 percent?

MR. SEBASTIAN: That's correct. That's one of the measures.

GOVERNOR SCOTT: And right now inflation is running 1.2, 1.5?

MR. SEBASTIAN: That's about right. It's meant to be a long-term target, so over a 10- or 20-year time horizon. So over time, we expect that to be -- our investment policy suggests that it will be in line with the 7.75.

We note that the pension plan is well diversified across asset classes. There are six broad ones that are included in the plan, global equity, fixed income, private equity, real estate, what's called strategic investments, which is a more opportunistic investment category, and cash investments.

We believe that's good diversification across a broad set of investment opportunities that are available. Within each asset class, there are not significant deviations of the plan's investments from the representation of that asset class, in other words, diversification across sectors, security, size, region, credit quality, duration, and so on. Where there are deviations from those broad asset class benchmarks, it's done in a risk controlled way with the intention of adding value over those asset class benchmarks through active management.

Within the private market asset classes, real estate and private equity, and to an extent, strategic investments, the investments are also well diversified across vintage year, across geography, property type, and other measures of different forms of those sorts of investments, again, pretty strong diversification of that portion of the portfolio.

A very important measure of risk control is adherence to the long-term investment policy. So asset allocation on a daily basis relative to that policy is monitored by staff very closely to ensure that there are not unacceptable deviations from that long-term policy, and to the extent there are deviations caused by market movements, that trades are made to move back in line with long-term policy.

We revisit the plan's design, the plan's investment policy on an annual basis, both informally and formally. As Ash had suggested in

June, we along with staff completed the most recent asset-liability and asset allocation study to analyze the long-term investment policy of the fund relative to its financial objectives and circumstances, and we'll have some more detail on that on a later agenda item.

And then lastly, we believe that adequate liquidity exists within the asset allocation of the fund to pay its monthly obligations.

I will skip --

GOVERNOR SCOTT: Can your liquidity change? Can your liquidity needs change very fast?

MR. SEBASTIAN: I'm sorry. Say that again.

GOVERNOR SCOTT: Can your liquidity needs change very fast? What would cause your liquidity to change quickly, rapidly? Anything?

MR. SEBASTIAN: I would imagine changes in the plan design could do that. Provision of liquidity would depend on the investment policy and the nature of the invitements in it. But as far as rapid, very rapid changes in liquidity needs, nothing immediately comes to mind. I'm not seeing any from my help back here.

MR. WILLIAMS: Generally speaking, the sort of things that in the very near term will affect liquidity demands are simply distributions, and the primary variable there would be DROP claims. And they move around a little bit, and they tend to cluster around fiscal year-end, and I believe to some degree calendar year-end.

The other thing would be capital calls, and what will drive capital calls -- this is when you have a committed capital investment structure where the investment manager will call capital when the investment environment is compelling for putting money to work.

So we're seeing, for example, an increasing rate of capital calls now, but those are very constrainable and estimable, because we know how much committed capital we have out there. It's not limitless. So we model it out very carefully. And basically, what we have done is created a cash position that we think gives us ample liquidity coverage. We're very focused on it. The Audit Committee has been particularly focused, particularly focused on that area and had us do a study and present it to them for that purpose.

GOVERNOR SCOTT: But you don't have lot of assets that are tied to capital calls, do you? You don't have that many?

MR. WILLIAMS: The private equity asset class is what? 75 percent? And currently, if we did give occasional positions in the strategic class, distressed debt funds, for example, those are commonly in a committed structure, or they certainly could be. So, no, it's not a lion's share of the portfolio.

GOVERNOR SCOTT: Okay. Thank you.

MR. SEBASTIAN: Just briefly, on this slide, I review graphically the market environment over the past year. These lines indicate growth of a dollar invested December 31, 2009, to the year ending December 31, 2010.

Just to note that the risk oriented or equity type asset classes, domestic and foreign equity, had strong performance over the year after a difficult July, earning $1.17 for domestic equity and $1.13 in terms of the growth of one dollar invested over that time period. Fixed income also earned a positive return over the lesser so than more risky type assets.

On liquidity, this is a regular part of our analysis of quarterly performance and portfolio positioning. This is just a summary of cash flows starting with the beginning market value of the DB

Plan, withdrawals either for benefit payments or transfers into the DC Plan, contributions into the plan or transfers over from the DC Plan, netting out to net cash flows, and then comparing that with net investment change over the past one quarter, the fourth quarter, and the one-year period. And we see that the fund continues to grow in market value as positive investment results have offset net negative cash flow.

I had mentioned rebalancing as a risk control method relative to long-term investment policy. That long-term investment policy is shown here in the beige bars with the white tops compared with the green bars, which are the actual asset allocation of the DB Plan as of the end of 2010. You essentially want to compare the green bars with the middle of the white boxes or white bars. That would represent a full alignment of actual allocations with the long-term policy allocations.

And we see that that is the case in every asset class of the six major ones in which the FRS invests. And also, the white boxes represent allowable ranges around those long-term policy targets. The FRS, like virtually all large institutional investors, has allowable bands around their targets within which a deviation is acceptable and beyond which allocations are moved back to the target.

And in each case, actual allocations were in line with those ranges, and therefore, we're in compliance with the investment policy, which we think is an important measure of risk control.

Performance on slide 14. We show the total FRS results over a number of trailing time periods relative to two performance comparisons. One is the performance benchmark, which is a reflection of the investment policy, the way in which the FRS invests, and then also the absolute nominal target rate of return, which as I mentioned before, is inflation plus 5 percent, which is expected over the long term to be reasonably consistent with the 7.75 percent actuarial rate of return rate.

I want to note that all returns for the FRS are net of all management fees, which we believe is the right way to compare performance to the benchmark, the real actual returns that were earned.

I would note first the beige bars representing the actual FRS relative to the performance benchmark, the green, that in each time period shown here, the FRS outperformed the performance benchmark, so positive results relative to the investment policy.

Relative to the absolute nominal target rate of return, this is meant to be a long-term return target. It's expected that the plan design and the plan's investment policy will outperform its target over periods of 10, 15, 20 years. We see that's the case in this slide here.

Performance over shorter periods, such as one year, three years, and five years, will be more driven by shorter term fluctuations in the equity markets. So again, this is meant to be a long-term comparison. Fifteen-year performance is positive, 7.4 percent shown in the beige bar, relative to 6.9 for the target rate of return. And over longer time periods, 15 through 30 years, the fund has earned a return greater than that of the target over every time period shown.

GOVERNOR SCOTT: I just hope you keep doing it.

MR. SEBASTIAN: So do we. We'll do our best.

Performance on this slide is essentially a ratio of the growth of a dollar invested in the Pension Plan, the DB Plan, versus the target, the performance benchmark. What's indicated here is that the Pension Plan earned $1.03 for every dollar represented by its investment policy over the period of roughly the last 10 years, a policy result. But importantly, that line doesn't have an enormous amount of volatility and always stays above that baseline, indicating that outperformance has been consistent and fairly steady over time.

GOVERNOR SCOTT: That's great.

MR. SEBASTIAN: Thank you.

This attribution analysis shows the margin of outperformance of the fund over the one-year and five-year periods. Let's look at the bar at the foot, the sort of bluish bar. The total fund indicates the difference between the actual fund's performance relative to the policy benchmarks, so 64 basis points, 6/10 of a percent for the one-year period, 21 basis point for the five-year period.

Those bars, the colored bars above that add up to those bottom figures, the intention being to separate the value added, either positive or negative, to the various asset classes of the six in which the FRS invests. We see in both cases performance relative to the benchmark has been positive, indicating outperformance.

Some standouts over the one-year period are foreign equity, where in particular some good investment choices among active management and emerging markets added value. And in fixed income, where we're overweight of -- still investment grade, but non-Treasury lower credit quality bond sectors continue to add value as those securities continue to come back from the events of 2008 and 2009.

Over the five-year period, a similar standout for foreign equity and also real estate, where some direct owned properties, which make up about 60 percent of that asset class, produced particularly good results.

Peer comparisons, as I mentioned, need to be to an extent taken with a grain of salt, given the caveats about different financial objectives and circumstances across plans. It's worthwhile to look at them, however.

The comparison that we do in this particular case is what's called a TUCS peer group, Trust Universe Comparison System, and it's the top ten defined benefit plans, so this is corporate and public defined benefit plans, the largest available in that pretty broad database, $1 trillion in total assets in this peer group, with median and average fund sizes of 105 and $109 billion, so very, very large, comparable to the size of the FRS DB Plan, and also not particular skewed by participants that are extremely larger than others. You can see that the median and the average being pretty close.

GOVERNOR SCOTT: What number are we as far as size?

MR. SEBASTIAN: You are -- I don't have the answer off the top of my head, but you would be in the top half of that top ten.

One comparison of interest is asset allocation of the DB Plan versus the top ten that I mentioned as shown on these piecharts here across the asset classes either that the DB Plan invests in or that are tracked by the peer group.

A couple of things to note are the greater than peers allocation to global equity. You see roughly 62 percent versus 52.7 percent for the top ten and a lower than peers allocation to alternative asset classes. In the case of the DB Plan, that would be real estate, private equity, and strategic investments. In the case of the top ten, that would be real estate and alternatives. And that's just a classification that includes private equity and also investments like hedge funds and other more difficult to classify --

GOVERNOR SCOTT: The top ten includes us? The top ten includes our numbers? It's not the other nine?

MR. SEBASTIAN: That's correct.

Performance is shown on slide 20. We show periods from one quarter through ten years. What we see is that -- so this is the returns of the DB Pension Plan versus the average of the top ten pension plans. We see results for the DB Plan that are competitive with peers, outperforming the quarter and one-year, and returns that are more similar to peer groups over the longer time periods. We believe that shows the DB Plan is competitive.

I would also note that these returns are gross of fees. Normally we show returns net of fees. In this case, these returns for the peer group were only available gross. I would make the note that analyses of the fees and costs paid by the DB Pension Plan suggests that it operates at a lower cost than its peers, while still delivering above benchmark performance. So were we to analyze these same results net of fees, we would probably see an even stronger showing for the DB Plan. So we believe these results look good relative to the top ten plans.

If there are no further questions on DB, I'll step relatively quickly through the other smaller plans that are overseen by the SBA, one being the Investment Plan, the DC Plan.

The executive summary, this is notes about performance. As you'll see on the following slides, the Investment Plan outperformed its aggregate benchmark over the periods that we analyze and track, indicating good design of the investment options and favorable selection of those options by the participants.

The total plan's expense ratio for the Investment Plan is lower than peers, both for the total fund category and relative to other DC plans, but also other DB alternatives. Management fees are lower for each investment category, each type of option. The Investment Plan we believe offers an appropriate number of options that span the risk and return spectrum, giving participants reasonable choices as to how to plan for their retirement and structure a portfolio appropriate for their risk tolerance and other factors.

And then lastly, the investment policy and the investment policy statement that codifies it are reviewed on a regular basis by Hewitt EnnisKnupp, your generalist consultant, and also staff, to indicate that it continues to be appropriate given the plans, goals, and objectives.

Slide 25 shows results for the Investment Plan. This has aggregated all the options included in the DC Plan up to one total fund return over one, three, and five years. And we do two comparisons. One is the average DC Plan, and the other is the total plan aggregate benchmark, which is a representation of the way the DC Plan is invested.

To dig a little deeper into these comparisons, we see the performance relative to the average DC plan trails a bit over the one-year and three-year periods and then is spot on over the five-year period, 4 percent.

We believe, as with the peer analysis we saw for the DB Plan, that in some cases the DC Plan universe comparisons need to be taken with a grain of salt. Your plan has its own objectives and its own participants, but it's worthwhile at least knowing how it stacks up to others.

What is a big driver of performance relative to the average DC Plan is that average has the inclusion of company stock as a significant investment option. Obviously, the SBA's Investment Plan cannot have company stock as an option, so it's not a significant component. It's not a component at all.

When equity markets are up, the inclusion of company stock in the average DC plan, which includes corporates, will drive those comparisons, so that's why we see a bit of trailing over the one- and three-year periods and matching for the five-year period. A more important performance comparison we believe is relative to the aggregate benchmark, which takes each option's benchmark in stocks, bonds, and other asset classes and rolls them up to the total plan. That's a representation of how well those options have done relative to their asset class representations, essentially their policy. And in each case, the total plan has achieved a return greater than the benchmark over each of the time periods shown here.

As I mentioned, fees are low relative to the peers. At the top we show the Investment Plan's expense ratio of 23 basis points, 0.23 percent relative to the peer corporate DC plan expense ratio that's the best DC peer group we have, lower than average fees, which we believe is a positive, since we know that dollars in fees paid reduce returns dollar for dollar.

It's interesting to compare the plan also relative to DB plans, and we do that in the bottom panel relative to average corporate funds and average public funds. And there we see the Investment Plan comes out looking good relative to both of those by even a larger margin, so lower than peers' costs in managing the plan.

CFO ATWATER: Governor, could I --

GOVERNOR SCOTT: Yes.

CFO ATWATER: So what is it about how we manage our plan that we have this kind of a better ratio?

MR. SEBASTIAN: It's a number of different factors. One is size and the ability to have economies of scale in that way. Another is using in some cases passive investment options that track benchmarking nexus and give assured market returns at low costs where it's appropriate to take -- to allocate that way as opposed to taking active risks with investment options that attempt to beat benchmarks.

So to the extent that you can minimize costs by assuring market returns where markets might be more efficient, but allow for the opportunity to beat the markets where they might be less efficient, that can lead to lower costs in the plan, and I think that's on thing that's happening here.

CFO ATWATER: It would seem like at some point if the rest of the globe was looking at the performance, which has been very satisfactory, that others might -- outside of our scale being of no value to us, why wouldn't others be following that same strategy?

MR. SEBASTIAN: They very well might. I think that these results, both in terms of fees and also performance over the benchmarks, represents the fact that the plan is designed very well and it's administered very well by the folks that you have on staff. So I would hope that others would attempt to imitate your success.

GOVERNOR SCOTT: Anything else?

CFO ATWATER: No, I believe that's it.

MR. SEBASTIAN: I'll round out the discussion of fees just on slide 27. We break down those same fee comparisons by option type, from large-cap equities through different equity types, international, bonds, balanced, and money market. In each case, the Investment Plan's fee is lower than the median available in the peer group, the median mutual fund, essentially, so again, a positive result.

GOVERNOR SCOTT: And that's tied to same size?

MR. SEBASTIAN: I think that's a driver of it, yes.

And the last two slides in this section show growth of the plan both in terms of plan size, assets under management, and also membership and growth has been pretty steady in the plan under both measures.

If there are not questions on DC, I'll move to Florida PRIME. Performance of the Florida PRIME short-term investment pool has been positive on an absolute basis and on a relative basis over short- and long-term time periods. We believe the PRIME is adequately diversified across issuers within the bond market. Its policy constrains the fund to invest in bonds that are appropriate, in other words, that are short term and have a low amount of interest rate risk and high quality and have a low amount of credit risk. We believe adequate liquidity exists within the PRIME to address the cash flow obligations.

And every year, as well as on an ongoing informal basis, Hewitt EnnisKnupp, in conjunction with staff, does an annual best practices report. We'll deliver our next one in June of this year that is really a soup to nuts review of everything regarding the policy and operations of the fund. And we believe that it is managed and administered in a way that's consistent with the best available practices.

GOVERNOR SCOTT: On PRIME, no one has the right to ask for their funds faster than you have the ability to liquidate? Like you're not investing longer than you're giving somebody the right to get their money back?

MR. SEBASTIAN: That's essentially true. Adequate liquidity exists with Fund A, the main fund for Florida PRIME. Within Fund B, you'll see an analysis later on that shows how the securities, some of which experienced difficulties in 2008, how those are paying out as they approach maturity. And those are paid out -- those funds are paid out to investors as available. But overall -- I'm sorry. Go ahead.

GOVERNOR SCOTT: It's just the ones that weren't liquid back then, right? So basically, you're not telling people they can get their money overnight when you're investing in 30-day paper?

MR. WILLIAMS: No, we're not, Governor. And in fact, the Legislature recognized the importance of that very point in 2008 when the legislation was redone reinventing the pool, if you will, because it set forth three very clear statutory priorities, which in rank order are safety, liquidity, and return, because if there was one lesson taken away unmistakably from 2007, it is that liquidity mismatches are a very bad thing. So we have redone the guidelines, the investment policy guidelines for the pool to reflect those of 2a-7-like funds under the SEC guidelines, extremely liquidity oriented, extremely high quality oriented, et cetera.

GOVERNOR SCOTT: So how long do people -- how long does -- like a municipality think they have their money, how long do they have to wait for their -- if they decide tomorrow -- they have a big blowup and they need money, what's your obligation to give them the money, how fast?

MR. WILLIAMS: We basically offer same day liquidity, which is pretty unique where we are. And there's a natural cyclicality to flows. It's not quite like commercial banking where you have a deposit base and there's a certain amount of daily churn and that's constant. This is seasonal.

At the tail end of the year when property tax revenues come in, that's when local treasuries swell. There tend to be heavy asset inflows at the very tail end of the year in November, December, for that reason. And then you start a runoff somewhere around the first quarter that gradually runs the balances down as they spin through money and then come in on the property tax cycle again.

Again, we have two Local Government Advisory Council members who know way more about local government finances than I do.

GOVERNOR SCOTT: Okay. But you don't have an issue that somebody could tomorrow and say, "I need money," and you don't have liquidity, and they have a right?

MR. WILLIAMS: No. We have a large number of accounts, a very large number of clients, and the daily transaction liquidity is quite small compared to what we're capable of handling.

GOVERNOR SCOTT: Okay. Thanks.

MR. SEBASTIAN: This slide shows a review of performance of Florida PRIME over a variety of time periods relative to a benchmark which is essentially a pool or a group of similar investment pools, and performance has been favorable over every time period shown here.

Liquidity, I'll add, or perhaps end with slide 34. We show here opening balance, deposits, transfers from Fund B, which I mentioned before which holds some securities that experienced difficulty in 2008, investment earnings and withdrawals, all netting out to an increase quarter over every quarter in the size of the fund. So the the flow into the fund from investment that results in deposits is positive.

Actually, I'll end with one other. Slide 37 is the tail end of a table which shows Fund B distributions to participants. Again, as securities mature within that fund, they're transferred into Fund A and transferred out to the participants in the pool. 81.9 percent as of December 22, 2010, of that market value has been paid out.

And then lastly, the CAT Fund, the Hurricane

Catastrophe Fund. The executive summary, again, performance of the CAT Fund has been strong over the periods we analyzed on an absolute basis and a relative basis relative to the benchmark. We believe the CAT Fund is adequately diversified across issuers. As with PRIME, the investment policy constrains the Fund to appropriate types of bonds, short term and high quality. We believe adequate liquidity exists in the fund. And as with the other funds, the investment policy is revisited on an informal and formal basis on a regular basis to ensure that its guidelines are appropriate, given consideration of its goals and objectives.

Flow into the fund is positive. This is slide 42. Here we show net contributions and withdrawals and investment change. The fund has increased in size over the quarter and one-year period by the amount of about 870 million and 1.4 billion.

And I will end with a summary of performance, which is that performance has been positive relative to the performance benchmark over the quarter and one-year period, trailed on a modest basis over the three- and five-year, but over the ten-year, over the long-term time period, has achieved its goal of beating its performance benchmark.

That concludes our materials, and if -- I'll take any further questions you may have, pleased.

GOVERNOR SCOTT: Does anybody have any questions?

Thank you very much.

MR. WILLIAMS: Thank you, Mike.

Why don't we then move ahead, if we may, with the standing reports. I would like to recognize John Hill from the Investment Advisory Council.

MR. HILL: Good afternoon. I'm John Hill, and I'm the outgoing chairman of the IAC. Thank for your time today, Trustees.

So I'm going to deliver a brief report on our meeting yesterday. So we had a meeting yesterday, March 8th, with our CIO, Mr. Ash Williams, and his team at the SBA. There were -- as Mr. Williams indicated, there were two new IAC members who were introduced, and that was Martin Garcia and Chuck Newman. And we also elected new officers for this next year, so Rob Gidel is now the incoming chairman and David Grain is our vice chairman.

GOVERNOR SCOTT: Congratulations.

MR. HILL: The meeting included the following: We started off with a detailed review by Kevin

SigRist, who is our deputy executive director, on the financial performance of the State Pension Fund. And the performance has been good, and particularly very good most recently, as Ash indicated. An update on recent investments and capital calls and distributions, which are all consistent with the approved asset allocation and investment strategy was overviewed for us.

We then moved to a discussion with Hewitt EnnisKnupp, some of which Mike just went through with you, where they reviewed the Fund's current asset allocation relative to different peer groups, which generally supported the current asset allocation plan. They also reviewed the relative financial performance of the fund, analyzing the risk versus return models, which also illustrated that the SBA fund was performing well and in line with its peers while attempting to prudently manage risk.

And finally, what you didn't hear yet is that they presented information regarding determining actuarially the soundness of the plan and the process involved in estimating future liabilities and other pension plan assumptions, so we had a good discussion from the actuarial point of view.

The next thing we did was that Cambridge Associates gave us a detailed presentation regarding hedge fund investing, including the different types of hedge funds and their historical returns and their relative risk. And Cambridge highlighted the use of hedge funds by other pension funds to improve overall returns, mitigate volatility, and provide diversification. And I think they're going to summarize that presentation for you today.

And then our meeting concluded with a discussion regarding the currently approved asset allocation strategy, with the IAC agreeing that it remains supportive of the plan approved last year, subject to the new Trustees' perspective and potential systemic changes that might occur to the plan after this legislative session and how that will affect future liabilities of the plan.

So that concludes my report. I'm happy to answer any questions.

GOVERNOR SCOTT: Do you feel comfortable you always get -- you have access to all the information you need and access to every employee you need?

MR. HILL: Yes. We've been -- I've been

comfortable with complete disclosure and access to anything that I needed. I would say that, you know, I'm going on my fourth year on the IAC, and we've been very favorably impressed with Ash and the team and the management of the fund and the professional approach they take to it.

GOVERNOR SCOTT: Thank you.

ATTORNEY GENERAL BONDI: Thank you for your service.

MR. HILL: Thank you very much.

GOVERNOR SCOTT: John, maybe if you wanted to pass the question. Do we have a sense now -- I saw the -- I guess June or July was the last time we had certified our funded ratio in our pension plan. Do we have --

MR. WILLIAMS: It's actually done -- excuse me. It's actually done in the fourth quarter of each year using fiscal year-end numbers.

GOVERNOR SCOTT: Okay. Given where we're at today on our balances, would you care to venture as to where you think we would be at?

MR. WILLIAMS: We touched on that yesterday, and we're going to be coming into that area in just a minute.

GOVERNOR SCOTT: Okay. I'll wait for that.

MR. WILLIAMS: So you might want to hold that thought.

CFO ATWATER: Sure.

MR. WILLIAMS: The short answer is, given the smoothing conventions, et cetera, probably not too much change. But Mr. Davis is going to revisit a number of variables that will affect it one way or another and could pass through to the investment policy, which is exactly the meat of today's meeting, and that's coming up in just a moment.

GOVERNOR SCOTT: Thank you. Thank you, John.

MR. WILLIAMS: Thank you, Mr. Hill.

Why don't we then move ahead, if we may, and ask the chairman of the Participant Local Government Advisory Council, Ms. Patsy Heffner.

GOVERNOR SCOTT: Good afternoon.

MS. HEFFNER: Good afternoon. Thank you for the opportunity to present to you today.

Since your last meeting of the Trustees on December the 7th, we've had one meeting of our advisory council on February the 16th, and our next quarterly meeting is scheduled for June the 15th at the SBA office here in Tallahassee.

The council continues to work on several issues designed to improve the operations and client services and investment and management of Florida PRIME. And if you'll forgive me, I'm going to read this report, because I don't want to misquote any of the figures in it.

Most recently, over the quarter ending December 31, 2010, participant deposits totaled 6.01 billion. Participant withdrawals totaled 4.12 billion, for a net increase of approximately 1.94 billion, or 36 percent. During the fourth quarter, Florida PRIME delivered an aggregate of 4.35 million in investment earnings for its investors.

Strong cash flows continued into 2011 with Florida PRIME's assets piercing 7.5 billion in late January, the first time the pool has closed above that level since April of 2008. Florida PRIME was valued at 7.385 billion as of February the 12th, 2011.

For the period ending December 31, 2011, Florida PRIME has performed exceptionally well in the current interest rate environment, outperforming its investment benchmark over all time periods. For pool investors, Florida PRIME generated excess returns of approximately 14 basis points over the last three months, 12 basis point over the last 12 months, and 8 basis points over the last three years. Florida PRIME's seven-day SEC yield was .27 percent as of February 21, 2011.

On December 21, 2010, the Auditor General distributed the fiscal year 2010 financial audit to all PRIME and Fund B participants with no instances of noncompliance or material deficiencies in internal controls. On February the 9th, the council distributed its 2011 biennial report.

Fund B has continued to pay principal and interest, with cumulative distributions to participants of 1.656375 as of February the 8th of 2011. As a proportion of their original principal amount, 82.4 percent has been returned to Fund B investors.

GOVERNOR SCOTT: Thank you. Do you feel comfortable you're getting access to all the information and people you need?

MS. HEFFNER: Yes, we do. We were actually put together as the voice and the eyes and the ears of the participants of the local governments, and we've had absolute transparency and complete cooperation from the SBA staff.

GOVERNOR SCOTT: Thank you.

ATTORNEY GENERAL BONDI: Thank you.

CFO ATWATER: Thank you.

MR. WILLIAMS: Thank you, Ms. Heffner.

Mr. Bill Sweeney, Chairman of the Audit Committee.

GOVERNOR SCOTT: The easiest job, right, the Audit Committee. Never any criticism.

MR. SWEENEY: The Audit Committee was formed in '03, late '03, so it's relatively new. And since the unpleasantness of, say, '07, '08, the Audit Committee was meeting quarterly and now we meet monthly or more frequently, and sometimes it's scintillating and interesting for our meetings, and so we have furnished you with those minutes.

But since the Trustees has started meeting in this forum, that is, a special forum to this, we have devised certain things, because we are your committee. We are your Audit Committee, and we were given directions and we consulted with the Board, and we had three priorities which we have I think substantiality completed.

One of them -- the first one was troublesome to me when I first came to the Board was that we had about 218 outstanding recommendations from our external auditors, the Auditor General, and our internal auditors. These recommendations were the result of audits from the preceding four years and had little or no resolution. And so we have been working through this. This has been a priority to implement these recommendations. And so we've gone from 218 as of January 1, '09, and I think we have 14 left, and they'll be done at the end of June.

Now, obviously, when you have continuing audits like we do and internal audits, you're going to have more recommendations. But these were very stale recommendations and I think would subject the Board to criticism had they not been addressed.

And now I would say that in the last two years, I think management has rigorously attended this. And, of course, we go over this every month and make sure that we're curing the problems.

CFO ATWATER: Governor, could I ask --

GOVERNOR SCOTT: Yes.

CFO ATWATER: Thank you, sir. I appreciate that. Let me just be sure I have that right. Where did the 218 findings come from?

MR. SWEENEY: They came from three different external audits. They came from OPPAGA, and they came from the Auditor General, and they came from the internal audit. And they were accumulated over -- these preceded -- I think the oldest one, the ones that I can remember were from '04. And so that was something that was very concerning.

CFO ATWATER: Yes. So when was the last external audit performed?

MR. SWEENEY: That's my next item. The next direction that we had from the Trustees was to consider hiring an external auditor to do an audit on the DC and the DB Plans. We had never had a financial statement for either fund. And so as of last June 30th, we had financial statements for each Fund, and as of December, we had -- through a competitive selection process, we had EY audit those funds. And so each of those funds now have a financial statement and an audit by an independent outside auditor for the first time.

Now, that's not to say that some of the funds were not audited as a part of the statewide audit through the Auditor General, but this is the first time we've had an independent audit of the two pension funds.

We do have other audits -- and this is another point that we have tried to do. We have now asked that all the audits, the CAT Fund and -- we have all kinds of real estate audits that we own, the fund owns, and we have independent audits there.

And we have directed that all the audits come through the Audit Committee. And some of these funds, the financial advisor was picking his own auditor. So we're trying to increase the independence and have, in effect, a direct report to this board.

CFO ATWATER: Did the external audits audit the performance of the fund staying within the allocations, or did they also the audit management practices or risk management practices?

MR. SWEENEY: Well, of course, they were auditing financial statements, but in the preparation and the assistance with the financial statements, they have been advising on procedures. And we have had various parts of the fund audited for various procedures. And if you have questions about, say, private equity or something, we would be happy to have our internal or external auditors address your questions and look into the fund as you see fit.

CFO ATWATER: Well, I appreciate that, because I've been asking for about two months when was our last external audit done, and did it look at our management practices and our risk management practices and could someone show it to me. So you're saying one was done.

MR. SWEENEY: One was done, but it was an audit of our financial statements. And I can have them at the next meeting and we will talk to them about what you would like.

GOVERNOR SCOTT: Okay. So let me make sure I get this right. The fund itself, the balance sheet of the fund, have they been audited over the years? They have; right?

MR. SWEENEY: They've been -- the Auditor General audited them.

GOVERNOR SCOTT: Not a third party, not like E&Y?

MR. SWEENEY: Not an independent third party.

GOVERNOR SCOTT: That's interesting. I'm surprised.

MR. WILLIAMS: If I may add some clarification a little bit, the Auditor General historically has provided general oversight for the State Board in preparing and as it contributes to the State's capital. The direction we've taken recently was that a more private sector oriented -- the more appropriate approach would be to generate our own financials and subject them to third party commercial audit, which we've now done. And it's actually in the statute. That was adopted last June.

GOVERNOR SCOTT: Okay. And that was for June 30th?

MR. WILLIAMS: Correct. And the audits came out in December '10, and they've been distributed to all three of your offices.

GOVERNOR SCOTT: Right.

MR. WILLIAMS: To your other point, other controls, et cetera, we have numerous certifications that come from numerous places, which is exactly what we're cataloging, CFO, for your benefit. For example, you heard earlier in EnnisKnupp's comments objective perspective on controls, performance, et cetera, more performance than anything else in that particular thing.

But we also have asset class specific advisory reports at different times of the year brought up in the quarterly IAC meetings and brought to you in areas like private equity, real estate, et cetera, et cetera, where we have specialty consultants, as Cambridge is in the hedge fund area.

GOVERNOR SCOTT: Is there like a standard for the industry with what people do?

MR. SWEENEY: With what respect, Governor?

GOVERNOR SCOTT: Well, with regard to what the CFO was saying with regard to risk controls, things like that. Is there a standard for what the other funds do?

MR. SWEENEY: Well, we have -- there was a -- I guess Gunderson was talking about risk control and whether they should be reported directly to this Board or to the Audit Committee. We do have a gentleman in charge of the risk part of fund come and speak us. He doesn't work for us or doesn't report to us directly, but he speaks at our meetings every week.

You know, risk assessment, I know that is an important thing that people talk about and you read about in the journal all the time, but I would say it's a lot more difficult to implement, because what was a risk yesterday is not -- tomorrow there's some new risk. You're always constantly fighting the imagination of mankind, which I for one am going to come out a loser on that, but, I mean, you keep trying to create these prophylactic procedures, but -- it would be a fool's errand to think that you were ever going to perfect that system.

GOVERNOR SCOTT: It's always easy to be a

Monday morning quarterback on something that you couldn't anticipate.

MR. SWEENEY: We do enjoy a lot of those.

MR. WILLIAMS: To the point, though, there is one good point on the subject of is there a standard, is there a benchmark. The Board actually retained Deloitte to answer exactly that question and to say, please give us a best practice benchmark, a private sector registered investment advisor regulated by the SEC, number one; number two, analyze our current risk control mechanisms; number three, provide a gap analysis; and number four, please advise us on how to set up an independent risk management and compliance structure to eliminate that gap.

That risk management and compliance structure was initiated in December or November, the fourth quarter of 2009. It's under the leadership of Mr. Nelson, who is right back there with the red tie and is available to report to any of you directly, privately or publicly, at your pleasure.

We have in fact fully implemented his team. He has a team of people who provide compliance on the asset class level independent of each asset class reporting directly to him. He in turn reports directly to me. We have documented, written escalation procedures, so if there's ever a compliance issue with any asset class, we can be on it and address it immediately, I mean, within a trading day or two. And if there's not agreement at the asset class level on what compliance sees as an appropriate resolution, it can escalate up through a series of groups, senior investment group, operating group, to me individually.

We also have -- at each of the monthly Audit Committee meetings, I'm present, as is Mr. Nelson, who will report directly to the Audit Committee and will satisfy the chair and the committee members that whatever we do will make sense.

CFO ATWATER: How often will you do the Deloitte report? How often do we do that?

MR. WILLIAMS: Well, the Deloitte report is not --

GOVERNOR SCOTT: He has told you what you should do.

MR. WILLIAMS: That was a design effort. That was a one-on.

GOVERNOR SCOTT: So you don't need to do that once a year.

MR. WILLIAMS: Now what we're doing is,

whenever we do audits, we can audit compliance with our own compliance procedures. The Auditor General can do that, OPPAGA can do it, E&Y can do it. There are any number of folks that can do it.

GOVERNOR SCOTT: Do you all have a hot line that goes to the Inspector General?

MR. WILLIAMS: We have -- not only do we have a hot line; we have a hot line that all our vendors are made aware of so that if anybody anywhere has any knowledge -- we have a third-party contractor externally, so there's an 800 number. Every contractor we hire signs a form that says, "I know this number exists. I realize that if there's ever any indication of fraud or double-dealing, I can call this number and independently report it, and it will be addressed."

GOVERNOR SCOTT: And all of our assets that are controlled by a third party, we have outside independent auditors from there, from those companies?

MR. WILLIAMS: We don't necessarily have a separate independent auditor for each external asset manager, but they are named fiduciaries to us. And in some circumstances where, for example, directly owned real estate, if we have a holding company that holds the title to a piece of real estate, that's what Mr. Sweeney was just referring to, where we now put all of those on a cycle of independent commercial external audit under an auditor selected by our Audit Committee, with a scope established by our Audit Committee, and audit results reported to our Audit Committee.

ATTORNEY GENERAL BONDI: May I ask a question?

GOVERNOR SCOTT: Yes.

ATTORNEY GENERAL BONDI: And that's based on the statute that came about requiring --

MR. WILLIAMS: It's really --

ATTORNEY GENERAL BONDI: Can you explain that, the history? Last year they changed the statute requiring an independent auditor?

MR. WILLIAMS: The background on that, General Bondi, is that not too long after I got here, we began talking about how we were audited and how to deal with that. And there had been some issues raised in the media about has the SBA been submitted to appropriate external audit, et cetera.

There was some question as to whether the State Auditor General should be considered an independent auditor. I think any of you whose organizations have been audited by the Auditor

General would affirm that, yes, they are. And not only that, the AICPA that recognizes the Florida Auditor General as an independent auditor.

But nonetheless, perceptions matter in our business. So we discussed -- I discussed with the Trustees and Audit Committee members, IAC members, et cetera, the notion of why don't we create our own financials and go to commercial audit. That's the standard the world is on. Why would we put ourselves on a different and lower standard, or arguably lower standard? Let's get with the program and adopt best practice.

Everyone thought that was a good idea. The Audit Committee enthusiastically bought into it, as did the IAC. And we went with the idea, and n part, with the good graces of the former Senate president's leadership, we did get legislation adopted last year that put the requirement for the external financial statements in the statute, together with external third-party audit.

And we also put the Audit Committee itself in the statute as a requirement, because the Audit Committee was created, as Mr. Sweeney suggested, back in '03 not by legislative mandate, but by leadership of the Trustees and the staff who together said this would be a good thing to have.

ATTORNEY GENERAL BONDI: That's what I meant by -- that's what I didn't understand. That's great. Thank you.

MR. WILLIAMS: Sorry for the long answer.

MR. SWEENEY: And the independent outside audit, and it happens to be EY, that was requested by this Board before actually the legislation passed. And by the time the legislation passed, we had them on board and were working on the financial statements, and so it was just a confirming piece of legislation.

The final thing that we had worked on last time, I think if we have an opportunity, it would be -- I find it extremely interesting, and I think this Board would too, and that is the process of continuing education that we have undertaken for the Board.

There were computer generated programs that other firms, other national firms, people in New York train their employees with. And it's very difficult, especially when you're out in the sticks like we are -- there are some advantages to being out in the sticks. You don't hear all the rumors, and you can think for yourself, but there are some educational aspects. So we have encouraged the Board, and they have hired a person who is in charge of doing continuing education for our Board employees.

Of course, this helps in terms of the lawyers and their continuing education, the accountants, and some financial professional organizations to get their continuing education. But it also allows some of our younger people to grow within the organization by taking these courses.

And I think if you'll look at it, you'll be surprised -- I know I was -- as to the quality and the scope of these courses. And there are over 100 of them, and you can take them on the computer, take them at your own pace. I think this beats the old method of sending people out to some beach town to try to get a little continuing education between golf games.

I think that I've taken up more time than I expected. I hope that we will have your ideas or your suggestions for the Audit Committee the next time we meet. You can call me and we'll be happy to execute whatever you need to find out about. Thank you.

GOVERNOR SCOTT: Thank you. Could I ask a couple of questions?

MR. SWEENEY: Yes.

GOVERNOR SCOTT: First, do you feel comfortable you have access to the people and information you need?

MR. SWEENEY: Yes, sir, I think so.

GOVERNOR SCOTT: And do you feel comfortable that you're on the right path to the outside auditors' recommendations for changes? You feel comfortable you're on the path to get those implemented?

MR. SWEENEY: Yes. I think that was our principal grunt work that we spent two years grinding through each of these recommendations. Management has been cooperative on some of them, and some of them we've had a little tussle to get through, but I think we've worked through a lot of these.

And if you're only working on, let's say, last year's audit criticisms, you're in good shape. So we've whittle down the embarrassing 219 or whatever they were, and those -- all the pre-'09 audit criticisms will be erased by this June.

GOVERNOR SCOTT: Thank you very much.

CFO ATWATER: Governor, could I just ask

another question?

GOVERNOR SCOTT: Yes.

CFO ATWATER: I want to say thank you as well, and I look forward to visiting maybe in the next few days or the next week, you now, with you and whoever else was pointed to in the back as the red tie. I didn't get the name, but I'm looking forward to that opportunity.

MR. SWEENEY: I'll find the red tie.

CFO ATWATER: Great. And Mr. Williams as well. But the point is, that was just the example that was shared, Governor, is that we have issues where we're finding -- and this is going to happen in any organization -- the fund manager picking out the auditor. And if we have processes in place that allow us to find that on a regular basis and we don't wait till the seventh year to have somebody blow a gasket and call for an external audit, that's what we just need to know sitting here, is what processes are we following.

It's very easy to show us the results on the performance of each fund, but we also have a responsibility on how the process works and how well it's managed and managing the risk that's involved, and knowing that there are the tools in place to see it, spot it, find it, and address it, and that it comes to us.

So I look forward, Governor, to having some time with the team and coming back, as I'm sure every Trustee would, and offering whatever suggestions might be valuable to us to have a greater level of comfort.

MR. SWEENEY: Thank you.

GOVERNOR SCOTT: Thank you very much.

MR. WILLIAMS: Thank you, Mr. Chairman. Trustees, with your indulgence, I think I would like to go ahead and jump into the meat of what we're here to talk about today, which is the redo, the revisitation of the asset-liability study from last year and the ramifications it had for investment policy. So I would like to ask Mr. Rowland Davis of Hewitt EnnisKnupp to come forward and provide that background for you.

We're mindful of your time, so we're going to try to keep it moving as quickly as we can.

MR. DAVIS: Thank you. Good afternoon.

GOVERNOR SCOTT: Good afternoon.

MR. DAVIS: I am a bit of a specialist with the Hewitt EnnisKnupp team. I'm an actuary by training, and so my role is to focus on asset-liability studies. And the primary purpose of an asset-liability study is to address the one overarching question of how much overall portfolio risk is appropriate for the fund.

GOVERNOR SCOTT: Could I stop you just for a second?

MR. DAVIS: Yes.

GOVERNOR SCOTT: Can we take a 10-minute break and -- we'll take a 10-minute break and get restarted. I'm sorry.

(Recess from 2:23 p.m. to 2:59 p.m.)

GOVERNOR SCOTT: I apologize that we took such a long break and you all had to wait around. I hate the part when people have to wait on me. But thank you very much.

MR. DAVIS: No problem. So I will be brief.

Again, the role that I play is to try and address the question of how much overall risk is appropriate for the fund, and I do that by trying to but it into a risk management frame where we look not just at investment risk, but translate it into financial risk factors that are important for the plan cost and funded ratio of the plan.

So I'm going to skip and hit a couple of pages that I think are of interest, and we'll move kind of quickly.

The first chart I would like to go to is this one on page 61. The way we do our work is through projections and modeling, so we do a lot of simulations and make a lot of assumptions about what the future might look like, both good and bad. So this is a projection of the investment return from our model over a period ultimately of 30 years, but we show expected return and the range of possible returns in a 90 percent confidence band going one year on the left, where we have a huge amount of uncertainty. And then going forward, the uncertainty tends to diminish as you are able to average things over periods of years.

The trend line ultimately hits a level of just a little over 8 percent. So we don't set the actuary's assumption at 7 3/4, but an important note is that our assumptions are relatively consistent with what the actuary has been using to do those calculations based on long-term return on the fund.

GOVERNOR SCOTT: I don't want to have any of these 20 percent down years.

MR. DAVIS: Pardon?

GOVERNOR SCOTT: I don't want to have any of these 20 percent down years.

MR. DAVIS: I know. We wish we could avoid those. So the challenge to policy makers, policy setters is how much of that uncertainty is tolerable and sustainable, and that's what we try and wrestle with.

You can on the next slide see the effect of trying to remove all investment risk, so the green lines now would be 100 percent bond portfolio. And you can see that the band is much, much tighter, so you've removed a great deal of the risk. But the tradeoff is that it floats at a much lower point, and so that's where the tension is, giving up return to gain more certainty.

Some of the material that precedes this talks about how actuaries and the models for funding plans are different between the corporate world and the public plan world. Public plans have maintained a long-term focus, which means the volatility, short-term volatility is accepted and tried to deal with it so that you can achieve these higher returns and keep the cost low of the program.

Corporate plans have evolved over the last 20 years to a different perspective, where the short-term balance sheet issues are much more prominent because of corporate transactions, takeovers, mergers, acquisitions, bankruptcies, meaning that the pension obligation can move to the balance sheet at any point in time, so the issue of avoiding that near term uncertainty is much more critical. And the corporate world has moved in the direction to derisk their pension arrangements and exit them in many cases as well.

So there really are two different frames, and it's kind of important to keep that in mind. Our work has focused on the continuing frame of reference that most public plans look at, which is long-term cost management.

The importance of this sensitivity you can get a feel for. The actuary for your plan, which is Milliman, measures the sort of normal equilibrium cost of the plan at about 12 percent of payroll as it exists right now. So the theme would be that if we could earn 7 3/4 percent and maintain full funding, then you could sustain the plan at 12 percent of pay contributions going forward.

The rough part is that there's no certainty about that, so there's bumps in the road, but that will be sort of the long-term estimated sustainable cost of the plan. The question then becomes, well, how sensitive is that to this rate of return? And the answer is that for every 1 percent change in the return, you're going to get a 30 percent bump or drop in the cost.

For example, if you lose 1 percent of return for an extended period, if you thought 7 3/4, but you actually get 6 3/4, then the cost should not have been 12 percent. It should have been 15, over 15 percent. That's a 30 percent bump on top, so 12 percent times 1.3.

GOVERNOR SCOTT: So let me say that another way and see if you're saying the same thing. So instead of getting 7.75 percent return, we get 6.75 return --

MR. DAVIS: For a long period of time.

GOVERNOR SCOTT: Twenty years, whatever. So what impact would that have on -- and you probably can't answer it perfectly, but approximately how much would that reduce -- I guess we're about 13 percent underfunded now? It might be a little less now. How much would that increase that?

MR. DAVIS: The cost?

GOVERNOR SCOTT: Yes.

MR. DAVIS: The underlying sort of equilibrium cost of the plan would move from 12 percent of pay to about 15 to 16 percent of pay, so about a 4 percent, 4 percent of payroll increase in the equilibrium cost.

GOVERNOR SCOTT: You're saying you would have to put 4 percent more in to get that same return?

MR. DAVIS: Right.

GOVERNOR SCOTT: And you don't really know what the number would be as far as how much we would be underfunded?

MR. DAVIS: No, and that --

GOVERNOR SCOTT: That would be 4 percent and growing; right?

MR. DAVIS: Right. This would be a long-term equilibrium perspective. But if you have bad returns, then you would have to accept the bumpy road on all that.

GOVERNOR SCOTT: So what you're saying is that it would be 4 percent compounded somehow, by the 6.75, I guess.

MR. DAVIS: Yes. The main point is -- and these are all rule of thumb kind of estimates, because I'm not the plan actuary. But a little bit of extra return goes a long way to controlling the long-term cost of the plan.

And the other point -- I missed a slide. The previous one actually says it's not the actuary's estimate that determines what the real cost is going to be over the long term. It's what you actually earn. So that's why we work so hard with the staff to extract as good a return as we can while watching the risk.

GOVERNOR SCOTT: And with your current 29/71, over the next 15 years, how much would you go down as far as percentage and under after --

MR. DAVIS: How much would we go down?

GOVERNOR SCOTT: Yes, or increase.

MR. DAVIS: In terms of fine tuning things?

GOVERNOR SCOTT: Yes.

MR. DAVIS: As long as the perspective for the plan remains the long-term focus on controlling costs, in general, the kinds of variations that we would see probably would be within the 10 or maybe 15 percentage point band.

GOVERNOR SCOTT: Would it increase much ever over 71?

MR. DAVIS: Possibly a bit, but more likely the other side.

GOVERNOR SCOTT: So that 15 percent would not -- it might be --

MR. DAVIS: Right. And the plan had been at a higher -- we did a full study in 2010, and the prior one was in 2007. During that study, the recommendation was to dial down on the risk, and that was at 78 percent and went to 71 percent from the 2007 study.

GOVERNOR SCOTT: All right. Thank you.

MR. DAVIS: Okay. Let me move forward into the 2010 study. And I'm not going to go through too much of the material here. The bottom line message from the study last year was on this question of how much overall risk seems appropriate. The answer was, it seemed that you were just spot-on in the middle of what we call the comfort zone or acceptable range, so we didn't recommend any change up or down in the overall risk.

Then the next step was to explore if there were opportunities to get a better risk-adjusted return by a better use of the different asset classes, in particular, the strategic and opportunistic type of asset classes. The answer was yes. As we looked at a variety of different configurations, we found several that would improve results. The one that became the recommendation to the Trustees last year was one that would produce cost savings over a 15-year perspective of $2 billion and slightly lower the overall risk based on these financial measures that we looked at.

So that process is one where you do a lot of, again, forecasting. This chart, for example, is a forecast from last year of the rate of contribution as a percentage of payroll under the existing policy, 71 percent allocation, again, with these kind of confidence intervals of rates. So you can see a high level of uncertainty there, and this was the same thing for funded ratio.

What we do then is collapse a lot of that information into a risk-reward framework, and this chart becomes the punch line to our study. And I won't go into how it's constructed, but it's constructed in a way so it has a very easy visual interpretation, and it's all relative to the diagonal line there. And the interpretation is that if we plot all these points, points where you either dial up or down the risk from where you are now, which is the red line, if you can find points that are above the diagonal, those are places you would like to be. That gives you a good risk-reward tradeoff.

So the picture we saw last year was this, where there are no points above the diagonal. In fact, the current policy, which is at the crosshairs there, is in fact the best you could get from this particular analysis of long-term cost, pretty much in the middle of the range. So that was the main conclusion from the asset-liability part of the study.

Coming into this year, we updated on at least a rough basis how would this curve look reflecting things we know now that we didn't have knowledge of last year. The investment returns for calendar year 2010 were very strong, stronger than the model would have predicted, so that's one thing. The other thing is our assumption --

GOVERNOR SCOTT: Does that make you get more conservative?

MR. DAVIS: Pardon?

GOVERNOR SCOTT: Does that make you get more conservative?

MR. DAVIS: It does make me more conservative. As the plan gets more well funded, you take some risk off the table. That's the way our model adjusted. And if you get to the surplus situation, which this plan was at, then you do what you need to do to try and protect the surplus.

The other thing that has changed from last year, we are constantly reviewing our forward-looking assumptions. Our view now is that you probably will get paid a little more for taking risk than what we thought last year. That's because fixed income returns are a little lower than we would have expected from a year ago. So if you get paid more for taking risk, you know, it shifts things in the upward direction.

So how does that look? If you go to this chart, the red line is where we were last year. The dotted blue line would be reflecting those two things that I talked about, excellent returns during 2010, but also a somewhat higher expectation for the equity risk premium, what you get paid for taking risk going forward. The line shifts a little, but not dramatically.

And if you just put the same kind of logic in here and look for points above the diagonal, there's a few that just marginally are above. The acceptable range has shifted to the right a little bit, which would mean you're still very much in the comfort zone, but more so now at the lower end of that.

GOVERNOR SCOTT: I would have thought that as you got better returns, it would have moved to the left a little bit.

MR. DAVIS: That part, it did. But the part about expecting that you might get paid more for taking risk, that's a very powerful assumption in this modeling exercise. And because of that, we also express that. You know, we give you a sensitivity analysis. But that's a very important assumption, very, very critical to know what you've going to get paid for taking risk, and it more than offset the other movement.

So that's where we're sitting today, which is a comfortable place to be. The big unknown is the plan changes, and so we have done some very rough calculations. If the plan changes are significant, does it shift the curve? Yes, it does. Anything you do that would slow the growth of the liabilities will move you in a more conservative direction from an investment policy point of view.

So we did again a ballpark estimate that said if the COLA is phased out, no new employees are brought into the Defined Benefit Plan, and you add employee contributions, what might that curve look like. It might shift as much as 10 percentage points, so it's not inconsequential. Hence, the basic view that we presented to the IAC yesterday was, we're in a good place, last year's recommendations are still standing, but there's a big unknown, so we want to pause and review in the middle part of the year.

Now, the second part of this study was, okay, can we improve the risk-adjusted return by fiddling with the asset classes and maybe creating some new asset classes? That's an area where Mike Sebastian will come up and address. But before I leave, if there are any other questions on my part of it --

GOVERNOR SCOTT: Do you have any questions?

CFO ATWATER: Yes. Thank you, Governor.

Thank you. I'm curious. Just because I'm curious, do you have a sense -- would this be the right place to ask Ash what the funded ratio might be today?

MR. DAVIS: Yes, it would be the perfect place to ask. The liabilities as calculated by the actuary for purposes of these funding calculations, the number that gets highlighted and headlined was 138 billion last July 1st. My projections would indicate that come this July 1st, we might be somewhere around 145 million.

GOVERNOR SCOTT: Billion you mean?

MR. DAVIS: Billion. And the assets now of the Pension Plan are about 127 billion, so where will they be? June 30th, who knows? But if they're still at 127, even without further market movements from today, we would be near 90 percent funded using the market value of assets.

Now, the other thing that comes in, which I think Ash alluded to, is that the actuary in our calculations smooths out some of those year-to-year fluctuations, so the asset value that the actuary uses to calculate costs is not market value. It's basically a five-year average type value. I still think it will be around 90 percent or very close to 90 percent. So if you think in terms of at or near 90 percent, that's probably the right answer for the question.

GOVERNOR SCOTT: All right. Any other questions?

Thank you very much.

MR. SEBASTIAN: Good afternoon. Mike Sebastian again. Thanks very much. Roland covered the first part of our regular analysis of the investment policy of the DB Pension Plan. His analysis related to the asset-liability portion, which results in a recommendation of the overall appropriate risk posture of the Investment Plan, that being 71 percent to equity-like or risky assets and 29 percent to fixed income, bond or less risky assets. That's stage 1. And stage 2, after we have determined or agreed up the appropriate risk posture, is whether there's ways to improve risk-adjusted returns through diversification of those components in a better way.

The process that we walk through in order to get there starts with assumptions for a wide variety of asset classes, your traditional stocks and bonds, but also a variety of alternative asset classes, including commodities, timberland, hedge funds, and many others, basically a full set of opportunities to determine what might improve the adjusted returns and lower costs over a period of time. We review a broad set of those asset allocation policies to give a lot of choice of alternatives and ultimately narrow them down to three, one being a lower risk policy that will allow for better diversification and a reduction, a substantial reduction in risk in the Pension Plan.

Ultimately, the recommended policy that also had a reduction in risk relative to the current policy, but also increased expected returns through better diversification and more opportunistic investing, while lowering risk and volatility, also lowering cost over a 15-year projection horizon.

And then lastly, the near term policy, recognizing the fact that the recommended policy includes some changes which would require legislative relief to enact in the plan. There is currently a 10 percent overall limit to the aggregate value of private equity, venture capital, distressed debt, and hedge fund investments. So to the extent that in the future a legislative solution can be found to allow an increase beyond 10 percent, we can move to the recommended policy. The near term policy which is described later in this presentation is an interim step between the current and the recommended.

The reasoning that we using in recommending these changes were essentially threefold: One, to maintain, or more importantly, reduce the overall level of investment risk in the fund. We suggested doing that in a number of ways, number one, reducing the fund's overall exposure to the stock market. You will see that the recommended decrease is from 58 percent stock exposure in the plan to 52 percent to reduce risk and volatility, and then also to decrease the fund's use of a different kind of risk which is designed to increase returns over time, which is active management. Market risk is the largest component of the fund's risk, and the second is skilled active managers taking risks relative to asset class benchmarks in an attempt to beat the market and increase the plan's returns. We believe that the plan is well served by having that, but possibly it can be taken in a more efficient way. We recommend decreasing the use of active management in the public stock and bond markets and increasing it in other areas, such as strategic investments, where it might be taken more efficiently. Those two together result in a reduction of risk to the plan.

We recommend increasing diversification in investments. The plan is already well and adequately diversified. We recommend more. One is greater global diversification in public stock investments. That would result in an increase in the allocation to non-U.S. stocks from about one-third of the public stock investments to about one-half, with the idea being that that allows broader participation in worldwide economic growth and also a reduction in volatility and risk that comes with better diversification, and then also greater diversification into a broader array of investment types, in particular, toward alternative investments that can reduce risk to the plan by not moving in lockstep with the other portions of the fund's asset allocation and reducing the overall volatility. And that can be private debt investments, commodities, infrastructure, timberland, and also even hedge funds, which another one of your advisors, Cambridge Associates, will speak about in more detail in a minute.

And then lastly, a third driving force behind the changes was flexibility to take risks more efficiently. I already touched on this a bit, in the sense that some active risk to attempt to beat the market moves from bond and stock investments, which can be best served by thinking about a way to participate in economic growth through stock investments and protect the fund from downside risk in the bond investments, but then going with active market beating investments within the opportunistic investment or strategic investments category. We recommend over time to consider increasing that portion of the fund to about 11 percent of total assets to from around, on a market value basis, the around 4 or 5 percent that it is today.

ATTORNEY GENERAL BONDI: Could I ask a question?

GOVERNOR SCOTT: Sure.

ATTORNEY GENERAL BONDI: When you're talking about risk factors, where do hedge funds fall? High, medium, low growth?

MR. SEBASTIAN: Great question. If I might, I might to skip ahead a second to some performance results. Hedge funds are one of many possible components of strategic investments. Hedge funds we cannot view as an asset class or investment category in and of itself. It's just a legal structure. Lots of things can be called a hedge fund, and they can have a wide variety of fees, levels of transparency, liquidity, and types of performance, and to come to your question, levels of risk.

Some investors say that you ought to look at these things very closely, and we agree. We believe that it's not just hedge fund investments, but the best hedge fund investments and the ones that are an appropriate level of risk that are risk reducers at the total fund level for the SBA's DB Pension Plan.

You asked about risk, and I'll talk about return. This graph shows two things. One is, starting in 1994, the results of a hedge fund index published by a firm called HFR, 1994 being the earliest date at which good data is available, and at the same time, the performance results of the S&P 500 stock index of large cap U.S. stocks. This is just growth of a dollar invested in December of 1993 to the same value in December 2010.

We see some variation in the blue hedge fund line similar to that of the stock market, so there is some stock market exposure, but less volatility over time. The up-and-downs have been more muted. And at the same time, the end value is greater in this particular case than the S&P 500 stock index. So although this won't be the case over every smaller or shorter time period, in this case, hedge funds as a group had returns comparable to the U.S. stock market at a lower level of risk.

And you can see the same or even a better analysis on the right of that chart, where the two blue bars represent measures the hedge fund market, one from the Dow Jones Credit Suisse, one from the same firm, HFR, and then some major asset class comparisons, stocks of various sorts, U.S. and non-U.S., commodities on the far right, and then bonds in the middle. And we see that the hedge funds as a group, again, before any skillful portfolio selection on the part of your staff, have delivered risks that are lower, substantially lower than stocks -- there are also commodities shown here -- and are reasonably in the same level as what is produced by bonds, with returns that have been favorably comparable or comparable to stocks.

GOVERNOR SCOTT: But this is basically an annualized return? This is not tied to actual dollars invested; right? Because if you had a year where there was less money invested in hedge funds with less volatility and a year where there was more money invested with greater volatility, it wouldn't take into consideration that there was more money invested in those years.

MR. SEBASTIAN: That's absolute right. It does not consider that. It's a time weighted rate of return.

GOVERNOR SCOTT: All right.

MR. SEBASTIAN: Governor Scott had mentioned a desire to avoid 20 percent down years, that he wished he could promise that. And alternative investments and strategic investments won't deliver that with certainty either, but I just thought I would highlight on this slide the downside risk protection from hedge funds.

Again, as a class, before any portfolio selection, the blue bar -- well, to back up, this is an analysis of the down stock market months from 1994 to 2010, so markets in which the S&P 500 stock market index lost value. There were 73 of those months over that time period.

And what we see here in the two bars are average returns of hedge funds first, and then the stock market in gray. So a negative .69 percent for hedge funds, below zero, but a much more modest loss than the 4.05 percent for the S&P 500. So this is just a demonstration over a fairly long time period that hedge funds as a class have saved value when the market has been down.

GOVERNOR SCOTT: If you did this over a -- hedge funds really haven't been around that long, probably since '94; is that right? There wouldn't be any data, I guess, is the problem.

MR. SEBASTIAN: Good data -- data, period, starts in about 1990, and good data starts about

1994.

GOVERNOR SCOTT: So going back further wouldn't help you at all. You could look at the right side, I guess, I mean, the S&P 500, but not the hedge fund side.

MR. SEBASTIAN: Yes, that's right. Hedge funds have been around for a lot longer than that, but as a mature industry that had good data -- and good data is often the bane of these kind of analyses. We'll be glad to help out in any way we can, but the best data starts in the '90s.

GOVERNOR SCOTT: Right.

MR. SEBASTIAN: So to close on hedge funds and other alternative investments, there's certainly no free lunch, but correctly structured, they can play a role in the portfolio in a way -- provide a way of reducing risk and increasing risk-adjusted returns.

I'm going to close with a table that shows a few policy items. So moving from the top to the bottom, we see the various asset classes in which the DB Pension Plan is invested. We see the prior policy before the changes that were implemented by the Trustees in -- the then-Trustees in July 2010, or June 2010. That's on the left-hand side. On the far right is the expanded authority policy. That represents our recommendation, the farthest out of the three that I mentioned earlier. And in between is the transitional policy that reflects the fact that there are legislative limits on certain types of investments in the recommended policy.

The changes from left to right, first of all, a reduction in global equity, with the idea of reducing the risk in the plan from 58 percent to ultimately 52 percent. It's not shown here, but combining domestic and foreign equity into one global equity component, which we believe is best practice. We view stocks of all types being one part -- or part one of the broad global equity asset class. A modest reduction in investment grade fixed income, and elimination of the high yield component and rolling that into the strategic investments area, because it's believed that that fits better there. It's more of an opportunistic investment. No change to the real estate investment allocation. A very modest increase in private equity from 4 to 5 percent, and then an increase over time to the strategic investments category target, again which would include a wide variety of investments designed to take risk more efficiently, reduce overall risk, and increase risk-adjusted returns, up to 11 percent of the total fund.

We don't show, as we sometimes do, portfolio statistics at the bottom, but if we did, what we would see is expected returns that as we move from left to right, from the current to the recommended policy, expected returns increasing, risk decreasing, and the cost savings of the plan over a 15-year time horizon, which is what we modeled, increasing.

So the recommended policy is based on Rowland's and Hewitt EnnisKnupp's modeling work and the assumptions that flow into it. We expect from the move to the recommend policy a cost savings of $2 billion over 15 years based on better diversification and increased efficiency of taking risk. And so we believe that that is a great place for the fund to be over the long term.

And with that, I will ask for any questions.

CFO ATWATER: Could I ask a question?

GOVERNOR SCOTT: Sure.

CFO ATWATER: Thank you, Governor.

I just want to be sure I -- I know you went through it, but just to be sure I've got it, I'm on the page that's on the screen at the moment, and the prior policy of global equity, 58 percent, you footnoted that to be sure we saw that of that, if I'm following the footnote, domestics were 38 percent and foreign was 20.

MR. SEBASTIAN: That's right.

CFO ATWATER: So now under the expanded policy, expanded authority policy, it's at 52 percent total. But what were you suggesting would be domestic and foreign?

MR. SEBASTIAN: We are recommending to remove those explicit targets of 38 and 20 and combining them into an overall target of 52, so then the allocation for the U.S. and non-U.S. stocks would be driven by market movements. Right now it's much closer to a half and half split between U.S. and non-U.S. stocks. So you can imagine taking that 52, dividing it in half, and that's about how much will be invested domestically versus overseas.

CFO ATWATER: Thank you.

GOVERNOR SCOTT: Anything else?

ATTORNEY GENERAL BONDI: No, Governor.

GOVERNOR SCOTT: Thank you very much.

MR. SEBASTIAN: Thank you very much.

MR. WILLIAMS: Thank you, Mike.

So what we've teed up is the history of the work that was done on the asset-liability side, what the ramifications of that were for asset allocation. We've talked a little bit about the alternative area, framed up the somewhat counterintuitive notion that some of the alternatives can simultaneously reduce risk and increase returns.

Particularly on hedge fund area, we talked about aggregate hedge fund industry statistics. And as Mike pointed out, that is without any benefit for manager selection. Hedge funds in particular, not unlike venture capital, private equity, and certain other investment areas, are areas where selection of the right management partners are key.

To that end, we have the closing part of the presentation today, which is Cambridge Associates, who will talk for a moment about their processes for selecting and overseeing hedge fund managers, which we think are critical in terms of the overall success.

MR. MNOOKIN: Thank you, Ash. I'm Jim Mnookin. My colleague is Andre Mehta. We'll be doing this together.

We're from Cambridge Associates. We're a private, independent investment consulting firm that provides proactive advice based on independent research. Our only source of income is from our clients, the owners of assets, and our client list includes a number of public and government agencies, as well as sovereign wealth funds. We've been advising clients on hedge fund investments since the late '80s, although as Mike just reported, hedge fund investing did not become mainstream until the '90s.

Hedge funds are really investment vehicles that offer specialized investment strategies that endeavor to make money independent of the direction of stock or bond markets. Their legal structure is a partnership which has incentive fees where managers are rewarded for good performance. Unlike traditional equities and fixed income, it's not possible to invest in hedge funds passively through an index fund.

The advantages of investing in hedge funds is that they provide exposure to strategies not available elsewhere, that they can earn equity-like returns over the long run with less volatility, and they provide access to some of the most talented investment managers around. And as Ash just alluded, it's very important to be discriminating in selecting the hedge fund managers. You want to be aware of things such as liquidity, transparency, and leverage.

Broadly speaking, there are two main groups of hedge funds. One is multi-strategy, and the other is equity long/short. And in between, there's a third sort of sub-group that has flexible allocation, that can move where opportunities are to multi-strategy when there are opportunities in distressed or arbitrage situations and equity long/short when there are more opportunities there. And within each of these groups, there are finer subsets.

Before one starts investing in hedge funds, it's important to define the objectives of investing. And on this page, we have sort of an example of investment objectives. And these can include sort of a desire to earn returns over the risk-free rate, protect principal in down markets while participating in up markets, and a desire to diversify the sources of return in portfolios and reduce the overall volatility of the portfolio.

MR. MEHTA: Let me just add one comment to that. It's important to remember that there are multiple objectives for having hedge funds in a particular portfolio, so it's not just adding one thing, adding return or lowering risk, but there's really a combination of factors that come into play.

MR. MNOOKIN: And as you saw, in aggregate, Mike looked at data from '94 to 2010, to the average month when the S&P was down, what happened. What we have done in this slide is look at a 10-year period ending December 31, 2010, at different hedge fund strategies and sort of link together all the up months, up quarters for the S&P 500 linked to all the down quarters, and then have the cumulative performance.

And as you can see from the top panel, linking all the up quarters, the S&P during this 10-year period was up 385 percent, and the hedge funds were not able to keep up with that. But if you look at the middle bar where, if you link together all the down months, the S&P was down 76 percent, you can see that all of these strategies were able to protect principal. They weren't able to prevent the loss of money, but they were able to protect principal in the down months relative to the S&P.

And then at the bottom panel, you see how they've done in all markets. And because of the drops during the down months, you can see that over this 10-year period, investing in hedge funds has cumulative performance in excess of both the bond and equity markets.

MR. MEHTA: I wanted to spend a few minutes talking about the process by which we do our work and how we advise our clients such as the SBA.

What you see here on page 120 is a simple flow chart showing that there are approximately 10,000 hedge fund managers out there in existence, and we obviously want to try and find those that are most suitable and most prudent for our clients to invest in.

We find good ideas in a number of ways. We are contacted by many hedge funds directly, by nature of the high quality client base that we have. We get to know many of the analysts who work at these firms, some of the junior talent, if you will, as they develop, and progressively stay on top of them and keep track of them as they leave to launch their own firms. We also learn of interesting investment opportunities through our clients as well.

All things considered, we have a number of sources, and we basically take that and try to answer another set of questions, which are, you know, is there real talent there, is there something there that can be additive to our clients' portfolios. And we do that by trying to assess their strategy first and foremost, you know, first of all, can we understand it, and that's something that we should always be asking and everybody should be asking.

Second is, really, what's the source of their returns, that is, what is the market inefficiency that they're trying to exploit, why does that exist, how are they able to capture that inefficiency, and is that sustainable. If those criteria are met, we then do a deeper dive into the organization and the investment process. We're really trying to understand both things, because they're both extremely important.

Finally, we spend a lot of time thinking the about risk in a whole bunch of different ways. Certainly on the investment side, we're trying to understand what could go wrong, if something does go wrong, how bad could it be, but also trying to do, if you will, risk management ahead of time by trying to understand the organization, trying to do all the things that you might expect in terms of background checks of the various principals, confirming that the vendors, the brokers, and the auditors are in fact legitimate and that they do represent that particular hedge fund, and so forth. And by following this process, we've been able to prevent our clients from investing in some of the notable failures that have occurred over the past years.

I'm going to skip ahead a little bit to the process as it pertains to an organization like the SBA on page 125. You see two sides to this page. One side is at the program level. And we really do think of investing in hedge funds as not investing in one manager at a time, but really thinking about how they all relate to the other.

And as a result of that, the first step really is trying to understand the objectives of the organization, and in particular, what role hedge funds play for the SBA. And that will be different from an endowment or foundation or a private family that we may also advise. We also want to understand the particular constraints and the hot button issues that a something like the SBA will have. And in doing so, we try and to craft a document, sort of a statement of objectives, if you will, that really presents the guiding principles which we follow in the subsequent steps.

On the right-hand side, you see a fund level view of the process. It starts with informing the SBA of some of the various funds that are out there and talking about the tradeoffs between different funds, the strengths and weaknesses and so forth. We throw out a lot of data to try to really drill down and use examples in that approach.

We then introduce members of the team to various managers and start a dialogue going, start with the presentations and helping them to understand what it is that each specific hedge fund does and what makes one different from another. We spend time trying to cultivate that relationship with them in order to gain access, because many of the top tier hedge funds are very selective and can afford to be very selective about the type of institutions and clients that they take in.

Once the decision to proceed is made, we then work in support of the staff to provide all the data that we can, our analyses, our background checks, and so forth, in order to check off all the criteria that they have for their due diligence process and make sure that their requirements and processes are completed and so forth, down to the final point at which the actual investment is made.

Moving then on the right-hand side at the bottom -- I'm sorry, the left-hand side, the bottom left where we talk about monitoring the investments, this is something that is very crucial. It's not strictly a buy and hold approach. And there are lots of things that happen in this industry on an almost continual basis, and therefore, we spent a lot of time thinking about monitoring of the investments.

I want to just pause for a second on page 127, which puts in graphical terms the dispersion of returns or the range of returns among certain asset classes. You can see on the very left-hand side the range of returns for a bond or a core bond allocation, versus on the very right-hand side, the last two sets of bars, the range of returns for hedge funds.

Again, alluding to the fact that there are a lot of hedge funds out there, not all of them are very good. And so picking the right managers in particular and trying to access the top tier managers is important, so we spend a lot of time trying to think about who really has talent and really understand on a prospective, that is, on a forward-looking basis, who has the ability to generate the returns that we expect in a prudent way.

Moving to page 130, we talk about monitoring. We really focus, again, to the left-hand side or right-hand side, on two aspects. One is understanding the manager and on a frequent basis staying in touch with the manager, monitoring any news that might to come out about the manager, having calls with the manager anytime something appears that seems out of the ordinary, either good or bad, that the manager, for example, has an outsized positive return. We want to understand were they lucky, were they good, or is there something else that we're missing.

On a quarterly basis, we have formal calls with the managers that our clients invest in, really trying to understand performance, trying to understand any organizational changes, trying to understand what worked, what didn't work, and trying to understand how the manager is positioned for the market environment going forward.

On an annual basis, we have formal on-site meetings with the managers, although we also have meetings much more frequently if one of us happens to be traveling through their offices or in the same city that they're in.

Moving to the right-hand side, on the portfolio, there's lots of things that we try and monitor about the portfolio to really understand what the exposures are and how the portfolio is positioned. We want to try and understand liquidity, that is, how frequently can an investor take their money out of the fund and under what circumstances. We want to understand both the performance of the overall pool of assets as well as the allocations among the various strategies. We want to understand exposure, leverage, geographic exposures, and so forth.

Finally, on an annual basis, a team of senior people at our firm look at every one of our clients' portfolios to try and understand is there something that we're missing that we should be aware of to make sure that we aren't missing anything.

Skipping ahead a few more pages to 136, the data on this page is a table with a lot of numbers that represents the actual experience of a number of our clients. In the top panel you see a year-by-year review of their returns, at the top where it says "CA client mean," Cambridge Associates client mean. And at the bottom, you see the annualized trailing one, two, three, all the way up to ten years of performance.

The numbers I want to point out to you, which we've talked about a little in the past already, is that in certain years, especially when the markets are struggling, hedge funds have the ability, through the nature of their investment strategies, through the nature of being able to get out of the markets and not being beholden to a particular index, to really protect capital well. You see in 2002 and 2001 the positive performance, whereas the markets down below, you can see a negative loss in 2001 of almost 12 percent and 22 percent in 2001 and 2002.

In 2008, another year with severe losses, as we're all painfully aware, hedge funds delivered a disappointing negative 20 percent return. They lost 20 percent, which was the first down year, according to some of the hedge fund indices, since they first started in the early 1990s. While they did lose money, they did protect capital relative to the equity markets, so down 20-ish percent versus down 37 percent for the S&P 500.

And then down at the bottom, you can see that despite those losses over various time periods, the compound average annual has been quite good relative to the equity markets, solely an equity portfolio during these times periods. We don't think that that's necessarily the case each and every year, but over the long run, we would expect a pattern somewhat similar.

GOVERNOR SCOTT: Do you have the same data with the dollars, how much was invested?

MR. MEHTA: We do from our clients. It all depends on the specific client, where they were in their allocation cycle.

GOVERNOR SCOTT: But this is aggregate numbers; right?

MR. MEHTA: I'm sorry? These are actual numbers?

GOVERNOR SCOTT: These are aggregate numbers?

MR. MNOOKIN: These are actual numbers and actual portfolios, time weighted.

GOVERNOR SCOTT: Could you send me that with dollar numbers?

MR. MEHTA: Of course.

MR. MNOOKIN: And turning back to page 133, sort of in conclusion, we think investing in hedge funds provides an investor with the opportunity to invest in best-of-class managers who are flexible where they can invest, enabling an investor to diversify the economic sources of return. The result should be a portfolio that -- or investments that reduce the overall volatility of the portfolio and contribute positive to the returns over a full market cycle.

And we would be glad to entertain any questions.

GOVERNOR SCOTT: Thank you very much.

MR. MEHTA: Thank you.

MR. MNOOKIN: Thank you.

MR. WILLIAMS: Thank you, Trustees. That concludes our agenda. And I guess to tie it up, the appropriate question might be, are you comfortable with what you've heard and with us continuing to proceed in a prudent, disciplined, thoughtful, and patient manner under the interim investment policy guidelines that were outlined a moment ago? And we'll come back to you post session with the benefit of more knowledge, and in the June meeting we can provide a more fulsome recommendation of a more long-term nature.

GOVERNOR SCOTT: Let me just make sure. Right now you're investing under that middle column, those percentages; is that right?

MR. WILLIAMS: Correct. And I think the important thing to note here would be, consistent with the premise of the importance of getting manager selection right, this is not something that happens at a high rate of speed at all. This is time-consuming stuff.

GOVERNOR SCOTT: I'm sorry. Say that again, Ash.

MR. WILLIAMS: I said consistent with the emphasis that was given to the appropriateness of the manager selection and the priority that has to be placed on that, this is not a rapid process.

To give you an example, using the hedge funds as a specific example, we first started out in the spring of 2010 with a group of about 25 funds as rough input, as the initial recommendations from Cambridge. We cut that down to a group of about 12. We've since cut that down to a group of about five. The diligence process is still ongoing. So we're not talking about something where we're going to put a giant amount money out the door in a hurry.

GOVERNOR SCOTT: And, Ash, right now, where do hedge funds fit? Do they fit under strategic investments?

MR. WILLIAMS: Yes, sir.

GOVERNOR SCOTT: All right. So right now, your max is 6 percent?

MR. WILLIAMS: Yes, yes.

GOVERNOR SCOTT: Okay. I'm fine with that. Is everybody all right?

CFO ATWATER: Yes.

ATTORNEY GENERAL BONDI: I like the most prudent and cautious.

CFO ATWATER: Governor, I just want -- so at the moment, we're shooting for that to be our range in the interim; is that correct, Ash?

MR. WILLIAMS: Yes.

CFO ATWATER: The 6 percent number?

MR. WILLIAMS: And again --

GOVERNOR SCOTT: That's a max.

MR. WILLIAMS: That's a max. That's not a number we would rush toward at all. The actual percentage in hedge funds now is tiny, tiny, probably -- it's tiny. It's less than 1 percent.

CFO ATWATER: Okay. Great.

MR. WILLIAMS: And the point I'm making is that at the rate for doing this, this takes months. This is not something we're eager to put a billion dollars out in a matter of months. It's just not going to happen.

GOVERNOR SCOTT: As you can tell, what I want to understand better on all these is how many dollars. I mean, these percentages sound really good, but often there are more dollars invested at different times, and so it changes the -- if you look at actual dollars made or lost, I think it's relevant. I think we ought to be looking at that also as much as we can. I'm sure there's some of it we can't.

MR. WILLIAMS: Well, I think in more recent times, we can. Cambridge will prepare that information for us.

GOVERNOR SCOTT: Good. Okay.

MR. MNOOKIN: We have actual experience where the hedge fund portfolios of clients has sort of added to returns and reduced volatility over a 10-year time period. But we will get you the numbers, the dollars there.

It is really somewhat different than in the private equity model, but -- and you are absolutely right. You know, you don't want to look at something where all the money went in during a down period and the average investor lost money. That has not been the case, the experience of our investors.

GOVERNOR SCOTT: That sounds good.

MR. WILLIAMS: But the real takeaway is, you set the risk envelope, and we want to make sure we're meeting your expectations and following your instructions. So if you're comfortable, tell us, and if you're not, tell us.

GOVERNOR SCOTT: I think the presentation today was responsive to what we asked for, and so that's been --

CFO ATWATER: Yes.

MR. WILLIAMS: Thank you.

GOVERNOR SCOTT: And I'm sure we'll ask for more.

MR. WILLIAMS: So we'll hold our course?

GOVERNOR SCOTT: Yes.

MR. WILLIAMS: Thank you.

GOVERNOR SCOTT: Thank everybody for the presentation today and for the information, and this concludes the SBA meeting, and we'll see you soon.

All right. We're adjourned.

(Proceedings concluded at 3:51 p.m.)

CERTIFICATE OF REPORTER

STATE OF FLORIDA:

COUNTY OF LEON:

I, MARY ALLEN NEEL, Registered Professional Reporter, do hereby certify that the foregoing proceedings were taken before me at the time and place therein designated; that my shorthand notes were thereafter translated under my supervision; and the foregoing pages numbered 1 through 109 are a true and correct record of the aforesaid proceedings.

I FURTHER CERTIFY that I am not a relative, employee, attorney or counsel of any of the parties, nor relative or employee of such attorney or counsel, or financially interested in the foregoing action.

DATED THIS 5th day of May, 2011.

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