

**MERCED COUNTY
EMPLOYEES' RETIREMENT ASSOCIATION
INVESTMENT OBJECTIVES & POLICY STATEMENT**

Amended April 26, 2012

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***MERCED COUNTY EMPLOYEES' RETIREMENT ASSOCIATION
INVESTMENT OBJECTIVES AND POLICY STATEMENT***

PART I

POLICY PERSPECTIVES

1.0 INTRODUCTION AND POLICY STATEMENT

1.1 Introduction

The Merced County Employees' Retirement Association's Investment Objectives and Policy Statement is a document which establishes and outlines the responsibilities of the various parties that are associated with the management of the Retirement Association. In addition, this document states various control procedures to ensure that the Association is appropriately managed. Reports from investment managers, the custodian, consultant and others must verify that the Association is operating within the framework of the Association's guidelines.

1.2 Policy Statement

Notwithstanding any other provisions to the contrary, the policy of the Board of Trustees ("Board") of the Merced County Employees' Retirement Association ("Association") shall be to invest public funds in a manner that is consistent with the County Employees' Retirement Law of 1937, as well as State and Federal laws. The fundamental mission of the Retirement Association is to provide retirement and other benefits to plan participants and to invest Plan assets solely in the interest of Plan participants and beneficiaries.

2.0 POLICY SCOPE

This policy shall set forth guidance and requirements for the investment activities conducted by the Board. The funds eligible for investment are all those under the direct authority of the Retirement Board of Merced County.

3.0 POLICY OBJECTIVES

The basic objectives of the Board's investment program are the following:

3.1 Association Management Objectives:

1. Safety of funds invested;
2. Liquidity sufficient to meet all cash needs of the Association;
3. Investment performance that is competitive in the current market environment once the first two objectives have been satisfied.

3.2 Basic Goals:

The goals of the Board are to fund the Association's benefit payments, while assuming a risk posture that is consistent with the Board's risk tolerance (which is comparable to the risk of the Association's target asset mix), protect against loss of purchasing power by achieving rates of return above inflation, and seek to obtain a fully funded pension plan status.

3.3 Investment Objectives:

The Board's long-term investment objectives are as follows:

- 1) At a minimum, achieve a nominal return equivalent to the Association's actuarial interest rate.
- 2) Earn a total return that averages 4 to 6% in excess of the rate of inflation.
- 3) Exceed the return of the Association's passive, market-based, investment benchmark. Allocations to specific asset classes are based on the Association's target asset mix, which is based on the Association's asset allocation study. The most recent Asset Allocation Study was completed on July 16, 2009. Modifications to this target asset mix have been subsequently made in the areas of mid cap domestic equity and emerging markets equity. The previous Asset Allocation Study was completed on April 20, 2007.
- 4) Achieve a total Fund return ranking above the median of other public sector retirement funds. Risk-adjusted performance is expected to also be above that of the median pension fund.

3.4 Board's Responsibilities

The Board holds the fiduciary responsibility for the Association. The primary determinant of the Association's investment performance is the total Fund's asset allocation. Thus, the Board will set a reasonably diversified asset allocation target (including minimum and maximum allocations), which is expected to appropriately fund the Association's liabilities and meet its basic investment objectives. The basis for such a target asset allocation will be a study of the Association's pension liabilities and reasonable, alternative investment portfolios.

Detailed liability projections shall be analyzed to determine the factors influencing the Association's cash flow requirements. Sensitivity analyses will be prepared so that the Board may thoroughly evaluate the ability of alternative investment portfolios to fund the Association's liabilities. This study will also consider levels of Fund performance and total Plan funding volatility, such that risk is properly and prudently evaluated, and identify asset mix alternatives expected to match the risk tolerance of the Board. Thus, an exhaustive review of investment risk and asset/liability funding uncertainties will help ensure that an appropriate investment posture is assumed.

The Fund will be invested in a manner consistent with the County Employees' Retirement Law of 1937 and State laws. It is also the goal of the Board to manage the Fund

according to standards that are at least as high as those established by the Employee Retirement Income Security Act (ERISA). Therefore, the Board will act in a prudent manner and expect their investment managers to act as prudent experts.

If deemed appropriate, the Board may delegate fiduciary investment responsibility to qualified investment managers, with the managers serving at the sole pleasure of the Board. Similarly, the Board may hire other experts to assist in the management and oversight of the Association. When the Board hires external investment managers to manage fully discretionary portfolios for the Association, the investment manager agrees to act as a fiduciary and invest its entrusted assets for the sole benefit of the Association's members and beneficiaries. Also, in fulfilling its fiduciary responsibility, the Board will establish investment goals, objectives, policies, guidelines and benchmarks for the Fund, asset classes and investment managers.

3.5 Training and Education Policy

It is the policy of the Board to provide periodic training to Board members and staff in retirement administration and investment related issues through courses, conferences and seminars offered by various organizations, such as the California Association of Public Retirement Systems (CALAPRS), State Association of County Retirement Systems (SACRS), International Foundation of Employee Benefit Plans, the Institute for International Research, and the Association's investment consultant. The Board will also receive educational presentations on an as needed basis. It is the requirements of the Board at a minimum to have all Board members attend the CALAPRS New Trustees School within their first term.

3.6 Policies to Ensure Ethical and Prudent Action

The Retirement Association's staff shall be governed by the "prudent person rule," which shall be applied in the context of the Retirement Association's investment portfolio. Retirement staff shall perform due diligence according to established policies of the Board and written Retirement Office procedures. The Board's investment policies specify reasonable risks to be assumed by the investment portfolio. Ethical and prudent actions will be further controlled by the following:

- 1) The Retirement Administrator shall establish and document a system of internal controls, which shall be approved by the Association's Board. The controls shall be designed to prevent the loss of public funds arising from fraud, employee error, and misrepresentation by third parties, or imprudent actions by employees of the Retirement Association. Controls deemed most important include: control of collusion; separation of duties (e.g., separating transactions authority from accounting authorization); custodial safekeeping; and, clear delegation of authority. These controls will be supplied to the Association's custodian and will be complied with.
- 2) Staff involved in the oversight and monitoring of the Association's external investment managers and short term cash investing shall adhere to the Statement

of Economic Interest form, the Board of Retirement's Code of Ethics Education requirements and disclose any existing or potential conflicts of interests.

- 3) As stated in a March, 2008 Investigation Report by the Securities and Exchange Commission, public pension funds and their employees are subject to anti-fraud provisions of the federal securities laws and SEC Commission rules. One of these laws/rules states that securities transactions based on material, nonpublic information is a breach of a duty of trust or confidence. While it is unlikely that the Retirement Association's staff will be in possession of material nonpublic information, if such information is obtained, the Retirement Association's staff must disclose this information to the Board and vow not to take any action with respect to this information.
- 4) The staff shall act reasonably as custodians of the public trust, and shall recognize that the investment portfolio is subject to public review and evaluation. The overall management of the Retirement program shall be designed and managed with a degree of professionalism that is worthy of the public trust.
- 5) It is the policy of the Board to contract with a bank or financial institution for the safekeeping of securities owned by the Association. This service contract may cover several functions, including on-line computer systems for portfolio monitoring, securities lending, short term cash management, brokerage commission recapture, securities litigation reporting, and other banking or financial services.
- 6) It is the policy of the Board that all U. S. dollar denominated securities rendered for payment will be sent "delivery versus payment" (DVP) through the Federal Reserve System or through the Depository Trust Corporation. (The DTC is the major clearing house for listed equity securities traded in the United States.) This payment process ensures that the Association's funds are not released until the Association has received, through Federal Reserve wire or by physical delivery, the securities purchased. Any non-U. S. dollar denominated securities will be settled in accordance with local exchange practices.
- 7) Form ADV for each of the Association's managers will be obtained annually from the SEC web-site, advisorinfo.sec.gov. The forms will be reviewed for firm developments and regulatory issues.

3.7 Placement Agent Fee Policy

Recent additional disclosure requirements and restrictions have been instituted by public pension funds regarding placement agent fees. State of California legal requirements have been established that require placement agent fee policies in 2010. When a placement agent or investment consultant assists an investment management organization in obtaining new client accounts, any such compensation must be made public by the investment management organization and disclosed to the Association. It is the Association's policy to not pay any placement agent fee. The Association will also comply with the provisions of the

3.8 Securities Litigation Monitoring

The number of security class action cases has increased significantly and the size of the awards has also grown. Some law firms have specialized in this field or developed a level of expertise. While securities litigation monitoring is a function of most retirement plan's global custodians, many plans have established contracts with law firms to also provide securities litigation monitoring. The Retirement Association has also hired a law firm to focus on securities litigation monitoring.

To conduct securities litigation monitoring, it is necessary for the Retirement Association to provide the law firm access to the Association's custodial information. Typically, access to five to seven years of historical information is required, as well as on-going securities holding and transaction information. With this information, the law firm can monitor and identify holdings that are involved in lawsuits or awards that have been made in such lawsuits. The law firm will make sure that the Association has filed to be a part of these class actions.

No costs are charged to the Retirement Association for securities litigation monitoring by the law firm. If, however, the Retirement Association decides to be a lead plaintiff in a lawsuit, the law firm will be entitled to be paid for its legal services. A regular review of quarterly reports from the securities litigation monitor and custodian will be made

3.9 Policy Statement Monitoring

Monitoring of compliance with the Association's Investment Objectives & Policy Statement will be conducted in the following manner:

- 1) ***Portfolio investment compliance***
 - a) A quarterly worksheet will be developed based on the Association's Investment Objectives and Policy Statement. (This worksheet is enclosed in Appendix B.) This worksheet requires the investment managers to state if they are in compliance with each applicable policy. These quarterly worksheets will be e-mailed to the Retirement Association's office and to the Association's investment consultant.
 - b) Additional review and follow-up will be performed by the consultant, as required if there are any policy exceptions. Reports on this work will be provided in writing to the Board.
 - c) It should be noted that the above procedures apply to individually managed, separate account portfolios, not to commingled fund participations. Commingled fund managers are governed by the reporting requirement stated in section 4.2.

2) ***Annual policy reporting***

- a) As discussed below, once a year, the investment managers will be requested to provide a copy of their internal ethics policies, and all other internal policies that relate to the Association's portfolios.
- b) For the securities lending program, the custodian will provide a monthly and annual update on its securities lending program. Specific items to be covered in this update are stated in section 6.0, Securities Lending, below.

PART II

ASSOCIATION'S PORTFOLIO MANAGEMENT

4.0 INVESTMENT POLICIES

4.1 Diversification

As it is prudent to diversify investment risk, the Board has adopted a policy to invest in several institutionally acceptable asset classes. These are domestic equity (large and small capitalization), international equity (large, mid and small capitalization)-both developed and emerging markets, private equity fund of fund investments, domestic real estate (institutional quality properties held in closed-end or open-end commingled funds, global equity REITs (Real Estate Investment Trusts), and direct real estate property), domestic fixed income, high yield fixed income, TIPS (Treasury Inflation Protected Securities) and short-term investments (primarily due to the transactional nature of most managers' portfolios).

4.2 Commingled Fund Participations

The Board acknowledges that when it is in the best interest of the Association to invest in a commingled vehicle (i.e. collective fund or institutional mutual fund and limited partnerships), it is not possible to dictate specific investment guidelines and prohibitions. Periodically, the Board will review the differences and determine if the commingled fund remains in the best interest of the Association.

4.3 Style Orientation

As part of the diversified asset class investment approach of the Association, the Board will also seek to employ a diverse group of investment portfolio managers within a specific asset class, if the size of the asset class commitment warrants more than one investment manager. Investment style and market capitalization will be used to differentiate among managers in the same domestic and international equity asset classes. The purpose of this diversification is to allow participation in various phases of a market

cycle. Investment style diversification will also be applied to the Association's investments in other asset classes if deemed appropriate.

4.4 Investment Objectives

All of the previously mentioned asset classes are expected to:

- 1) Generate rates of return in excess of inflation. Equity investments should approach an average of 6 percent net of fees, above inflation over a full market cycle, or three- to five-year period. Fixed income investments should exceed inflation by an average of approximately 3 to 4 percent net of fees, over an interest rate cycle, or three to five years.
- 2) Exceed the return on the asset classes' market index (benchmark), or passive investment alternatives. These benchmarks are stated in Appendix C.
- 3) Achieve an asset class return ranking above the median over a full market cycle, or three to five years. Risk-adjusted performance (based on the Sharpe ratio) is expected to be above the median manager in each respective asset class, over a full market cycle.
- 4) The above three investment objectives apply to the Association. However, these same objectives also apply to the Association's individual investment managers. Investment managers are expected to outperform over a full market cycle, or three- to five-year period, their respective asset class market index or benchmark. During this three- to five-year period, the investment managers are also expected to outperform the median manager in their respective style group. Over shorter time periods, less than three-years, investment managers are expected to at least outperform the median manager in their respective style group.

4.5 Asset Allocation Plan and Target Asset Mix

The Association has established a target asset mix and allocation ranges based upon the most recent Asset Allocation Study report dated July 16, 2009. Modifications to this target asset mix have been subsequently made in the areas of mid cap domestic equity and emerging markets equity. The previous Asset Allocation Study was completed on April 20, 2007. The Association will review its asset allocation position as needed or a minimum of once every three to five years. Refer to Appendix C for the Association's Asset Allocation Plan and Target Asset Mix.

PART III

INVESTMENT GUIDELINES

5.0 INVESTMENT MANAGERS' RESPONSIBILITIES, POLICIES AND GUIDELINES

All investment managers hired by the Association will be registered investment advisors with the Securities and Exchange Commissions, or will be trust companies that are regulated by State and Federal Banking authorities. Such investment managers will maintain proper and adequate insurance coverage's including errors & omissions, surety bond, fiduciary liability, ERISA bond, etc. In addition, the Association's investment managers agree to notify the Board Chairman and the Retirement Administrator in writing if they are unable to continue acting in the capacity of a fiduciary or investment advisor.

5.1 Investment Managers' Responsibilities

As stated above, managers are expected to act as prudent experts in the management of a fully-discretionary account(s) for the Association and agree to be fiduciaries to the Association. In fulfilling their roles, managers will continually educate the Board about capital market developments that pertain to their area of investment expertise.

Investment managers are expected to meet applicable investment objectives over the designated time horizon. If such objectives become unreasonable for any reason, it is the manager's responsibility to communicate his/her reservations about the objectives in writing to the Board. Otherwise, failure to meet these objectives may result in dismissal.

Satisfying the quarterly portfolio reporting and monitoring requirements of the Association is also an important part of the manager's responsibilities. These requirements are stated in a subsequent section of this document. Past or any anticipated significant portfolio developments, as well as major changes in the firm's ownership, organizational structure and personnel, should be immediately communicated in writing via e-mail to the Board and its investment consultant. Such communication will in turn be provided to the Board members.

It is the responsibility of each investment manager to provide a current version of its internal code of ethics. Additionally, once a year the manager will provide updated copies of investment and other policies developed by the firm that are relevant to the Association and its portfolio(s).

Individual investment managers are hired by the Board to achieve the Board's goals and investment objectives. In addition, managers are hired to implement the Board's asset allocation decisions, as evidenced by stated fund target asset mix in Appendix C. To the extent possible, investment managers will be hired to fulfill the Board's diversification policies.

Managers are required to inform the Association of any regulatory investigations/ judgments and court cases relating to trading activities. If the managers conduct on-going internal reviews of trading activities, results of these reviews will be supplied to the Association. The managers hereby agree to supply this information and to answer the trading practice questions in the Compliance Certification Statement.

5.2 Investment Manager Policies

The investment policies governing each investment manager hired by the Association are as follows:

- 1) The investment manager is required to accept the responsibilities stated above. These responsibilities include acting as a prudent expert and agreeing to be a fiduciary to the Association. The manager will seek to satisfy the Board's investment objectives. If a problem exists with these objectives, it is the manager's responsibility to formally discuss these problems in a written communication to the Board. Also, the manager agrees to satisfy the Board's prescribed quarterly reporting requirements.
- 2) Under any and all capital market environments, the investment manager agrees to maintain the investment approach that it was hired to implement. Changes to the manager's investment decision making process are to be immediately reported in writing to the Board. On-going introspective research of the firm's investment process, analytics, inputs, and decision-making process will be regularly explained in writing to the Association. It is the responsibility of the investment manager to fully educate the Board as to the specifics of its investment process and internal research that may lead to changes in the firm's investment approach.
- 3) An investment portfolio constructed for the Association is expected to generally conform to other portfolios managed by the investment organization, exclusive of specific investment guidelines. When the Association's guidelines require the investment manager to manage a portfolio significantly different than its other portfolios, it is the responsibility of the manager to communicate in writing the potential impact of the Association's guidelines on the portfolio.
- 4) The manager will otherwise treat the Association's portfolio in a manner similar to other comparable portfolios in portfolio construction trading, and all other aspects.
- 5) The members of the investment management firm's research and portfolio teams are expected to comply with the CFA Standards of Practice and Code of Ethics. Any industry or regulatory disciplinary action taken against members of the firm's investment staff must be immediately reported in writing to the Board.
- 6) Portfolios managed for the Association are fully discretionary, but must meet the provisions of the Association's investment objectives and policies. Investment guidelines also exist for each investment manager within the major asset classes.
- 7) Unless otherwise specified, portfolios are to be fully invested in acceptable

investment securities. Under no circumstance shall an investment manager attempt to “market time” investments in its portfolio(s).

- 8) If the Board delegates proxy voting responsibilities to an investment manager, the manager agrees to vote all proxy ballots according to the best economic interest of the Association's members and in a manner consistent with the Board's proxy policies.
- 9) Investment managers agree to actively support the Association's securities lending and commission recapture programs.

5.3 Derivatives Investing Policies

1) Introduction

The brokerage community develops many new investment securities that are partially derived from the underlying characteristics of stocks, bonds, commodities, currencies, security indexes, etc. It has been painfully demonstrated that these securities, referred to as derivatives, had behavioral and performance characteristics that were unforeseen in certain extreme market circumstances, e.g. when liquidity in the derivatives markets was severely restricted. In such market environments, some derivative securities did not behave as expected and significant losses occurred.

From a historical perspective, for example, derivative securities such as options and futures have been in existence for many years and have successfully helped institutional investors mitigate risk. Therefore, some derivatives have solid and worthwhile investment purposes and their investment characteristics can be reasonably understood and identified. Other derivatives may have less worthwhile institutional investment purposes and their investment characteristics are difficult to understand and/or anticipate.

While the brokerage community is expected to continue to develop new securities (an example is inflation indexed bonds), there is a genuine need to allow the Association's managers to evaluate new securities and introduce them into their portfolios, given that the investment process followed by the investment managers complies with the subsequent provisions of this policy statement. This policy statement attempts to allow the Association's investment managers to exercise reasonable investment freedom, while minimizing the possibility of adverse implications for the Board.

2) Derivative Definition

There is virtually no disagreement in the basic definition of a derivative. This, however, is not the case when investors apply derivative policies to individual securities. For purposes of this policy statement, we reference the derivative definition in the August, 1994 Investment Company Institute paper entitled Investments In Derivatives by Registered Investment Companies: "A 'derivative'

commonly is defined as a financial instrument whose performance is derived, at least in part, from the performance of an underlying asset (such as a security or an index of securities)."¹

3) Types of Securities Included or Excluded

While most investors will accept the above definition, application of this definition to the types of securities available in the marketplace will produce significantly different lists of derivatives. Since this is an area of the marketplace that is likely to experience considerable change, provision must be made for the general characteristics of a derivative security, its evaluation and monitoring. Therefore, it seems most appropriate to not attempt to definitively list all of the derivative securities that are covered by the Association's policy statement. Instead, what will be explicitly stated is the investment process which governs derivative investments and the evaluation and monitoring requirements of this investment process.

4) Approach to Policy

Extensive research has been conducted on investment managers' general derivative investment policies and aspects relating to these investments. From this information and other sources of policy statements, an approach has been developed which states allowable derivative investments, limited allocation derivative investments and restricted derivative investments.

Those derivative securities not specified in the above three groups of securities must be evaluated in accordance with the following section entitled Derivative Investment Process. Therefore, if a derivative security is not referenced in the classifications listed in the Investment Restrictions and Derivatives Policy section below, the manager must evaluate the derivative based on the provisions of the Derivative Investment Process. If the security meets these provisions and the spirit of these policies, the manager may establish a prudent position in the instrument. Again, the manager must be able to demonstrate the appropriateness of such an investment in light of the Association's guidelines.

"Investments in Derivatives by Registered Investment Companies", August, 1994, Investment Company Institute, page 2. This document states the requirements of mutual funds regarding the investment in and oversight of derivative securities.

5) Counter-Party Evaluation

Before identifying the derivatives that fall into the classification sub-section in 7 below, the Association stresses the importance of the manner in which an investment manager evaluates the sellers or providers of derivative securities. When entering into a non-exchange traded derivative investment, the investment managers must fully evaluate the other side of the derivative transaction--the counter-parties to the trade. Due to the possibility of counter-party default, the Association's investment managers must evaluate the risks associated with the counter-party as if an investment were being made in the traditional securities issued by the counter-party.

At a minimum, the investment manager must evaluate the counter-party's corporate earnings stream, corporate asset quality, capitalization, corporate liquidity, Moody's and Standard & Poor's debt ratings and other fundamental investment and risk characteristics. For those counter-parties that are broker/dealers, they must have investment grade (Moody's & S&P rated) debt, be registered with the SEC and have significant net capital to protect against potential adverse market circumstances. For those counter-parties that are financial institutions (banks), they must have investment grade (Moody's & S&P rated) debt, total assets in excess of \$1 billion, and have significant net capital to protect against potential adverse market circumstances.

The investment manager must monitor individual investment and total portfolio exposure to counter-parties. Individual counter-party exposure must be well-diversified and not concentrated in a small number of organizations.

6) Purposes for Derivatives

As discussed above, the purposes for making derivative investments can be consistent with the Association's overall investment guidelines. To insure that inappropriate investment purposes are not included in individual manager's portfolios, the acceptable investment purposes for the use of derivatives are as follows:

- a. Mitigation of risk (or risk reduction). The use of futures, options and forward currency contracts to assist investment managers in mitigating portfolio risk.
- b. Useful substitute for an existing, traditional investment. In certain circumstances it may be cheaper, quicker or easier to invest in a derivative instrument or security rather than transacting in the cash or traditional security market.
- c. Provides investment value to the portfolio, while being consistent with the Association's overall and specific investment policies.
- d. Obtains investment exposure that is appropriate with the manager's investment strategy and the Association's investment guidelines, but could not be made through traditional investment securities.

Given that one or more of these investment purposes are clearly met, it is the responsibility of the investment manager to explain and demonstrate how derivative investments impact portfolio risk and the context of the investment within the overall portfolio.

Any other derivative investment purpose is not allowed. For example, derivatives may not be introduced into the portfolio to create economic leverage or to create investment exposures that are otherwise excluded by the Association's investment policies. However, if a manager develops an investment purpose other than those listed above which he/she feels is legitimate and consistent with the spirit of the Association's guidelines, this purpose should be proposed in writing to the Board.

7) Investment Restrictions and Derivatives Policy

For the purpose of these guidelines, convertible debt, traditional zero coupon bonds, mortgage pass-through securities and asset-backed securities are not viewed as derivatives. Although these investment securities may not be classified as derivatives, they are required to meet all of the guidelines established for the Association's traditional investments.

Based upon the factors enumerated in the above section entitled Approach to Policy, the following guidelines have been established:

Allowable derivative investments

- a. Stable and well-structured mortgage CMO's (collateralized mortgage obligations)
- b. Financial futures (if exchange traded)
- c. Currency forward contracts and currency options (exchange and OTC traded)

Derivative investments with allocation limits

- a. Interest only mortgage CMO's
- b. Principal only mortgage CMO's
- c. Interest rate swaps
- d. Options (if exchange traded)
- e. Caps and floors as they apply to the above stated allowable derivative investments

Derivative investments with allocation limits, as listed above, may not represent more than 5% of the individual portfolio manager's assets (based on market value) managed for the Association. At the same time, derivative investments with allocation limits in aggregate may not expose the individual manager's portfolio to losses in excess of 5% of the manager's total assets. Such an allocation limit is established to protect the market value of the manager's portfolio from excessive downside risk. In addition, the use of interest rate swaps, options, caps and floors may be used only for defensive investment purposes.

Estimates of exposure to market value loss should be consistent with the Value-at Risk (VAR) method or a generally comparable risk measurement procedure. VAR is one widely used method for creating a common unit of measurement for risk. It is the maximum dollar (or other currency) amount that a position or portfolio is expected to lose within a specified period of time given a specified probability. There are a number of approaches to computing VAR, and the results are quite sensitive to the assumptions made and the model used. Managers investing in the above defined limited allocation derivative instruments should ensure that portfolio exposure is maintained within the stated constraints and communicate the assumptions and model used to estimate VAR annually to the Board.

Restricted derivative investments

- a. Inverse floating rate notes and bonds
- b. Structured notes

Restricted derivatives cannot be held in the Association's portfolios at any time. As stated previously, those derivatives that do not fall into the above categories must meet the Monitoring and Reporting Requirements and the provisions in the Derivative Investment Process sections before they can be purchased.

8) Risk Analysis and Monitoring of Derivatives

Sub-section 10 below, Reporting Requirements, covers several investment and follow-up monitoring aspects expected of the manager's derivative investments program, but this particular section deals with the specific assessment of risk analysis and monitoring. For those securities that are classified as derivative investments with allocation limits, as specified in sub-section 7 above, the investment managers are required to test and measure derivative investment sensitivities to changes in key risk factors. Examples of key risk factors are as follows:

- a. Extreme changes in interest rates
- b. Extreme changes in volatility
- c. Extreme changes in liquidity
- d. Extreme changes in credit quality
- e. Extreme changes in underlying cash market prices

Such risk factors will be assessed prior to initial investment and on an on-going periodic basis, most likely on a quarterly basis. Results of such risk testing on derivative investments with allocation limits (as specified in sub-section 7 above) will be supplied to the Association on an annual basis (December 31). If the investment managers identify additional risks that should be evaluated, these other risk factors should be added to the list and handled in a manner consistent with the previously stated approach.

9) Derivative Investment Process

Investment managers are expected to cover the following issues before purchasing a derivative instrument or security:

- a. Determine if the purpose for investing in a derivative security is consistent with one or more of the purposes in the previous section entitled Purposes for Derivatives.
- b. Determine where the security fits into the classification system, if at all, stated in the Investment Restrictions and Derivatives Policy sub-section.
- c. Evaluate, at a minimum, the counter-party risk and the risks stated in the Risk Analysis and Monitoring section of the derivatives policy.
- d. Evaluate the derivative in a comparably thorough manner as the firm would any other traditional investment opportunity.

10) Reporting Requirements

It is the responsibility of the Association's investment managers to certify and demonstrate that their portfolios are in compliance with the Association's overall guidelines as well as those that apply to derivative investments. On an annual basis (December 31), the Association's investment managers will provide the following minimum monitoring information on derivative securities that are classified as derivative investments with allocation limits (as specified in sub-section 7 above):

- a. A general statement from the manager that his/her portfolio is in compliance with the Association's derivatives policy.
- b. When stating the market value of the derivatives exposure, the manager will specify the security pricing sources. Primary pricing sources will be exchange listed prices, independent third party pricing services, or the average of three broker/dealer prices.
- c. A statement of the risks (credit risk-an evaluation of potential counter-party default on obligations, market risk-percent of portfolio invested in derivatives, and any other relevant risks) associated with the derivative investments.
- d. The expected risk/reward relationship for the derivative investments.
- e. Potential adverse impact on market values if extreme adverse market movements occur.
- f. A statement regarding the liquidity of the derivative investments.
- g. Summary comments on the firm's list of approved counter-parties and a statement regarding any changes to this list.
- h. An overall statement discussing the legal and regulatory risks associated with the portfolio manager's investments in derivatives.

5.4 Investment Manager Guidelines

1) Diversification, Liquidity & Restrictions

Portfolio holdings are expected to be well-diversified, so as to avoid excessive volatility and to be liquid. Only investments in liquid securities² are allowed, exclusive of private equity. In addition, short selling, use of leverage or margin and investments in commodities is prohibited.

2) Cash & Equivalents

Transactional cash, portfolio assets that are temporarily not invested in authorized, longer term securities as stated below, may either be directly invested in allowable high-grade short-term fixed income investments or may be "swept" into the Association's custodial short-term investment (money market) commingled fund. Allowable high-grade, short-term fixed income investments are as follows: certificates of deposit, commercial paper, U. S. Treasury bills and repurchase agreements. These investments will have short maturities, typically less than 90 days, but none more than 1 year. If an investment is made in the custodian's money market fund, it is the responsibility of the investment manager to make sure that the money market fund has investment guidelines that comply with the Association's investment objectives and policy statement. (At this time, it is not contemplated to allow investment managers to invest in money market funds other than those offered by the custodian. To the extent that an investment manager wishes to use non-custodian provided money market funds, this issue must be addressed in writing and directed to the Board.)

3) Domestic Equity Portfolios - Large Capitalization

The types of assets that may be held in large capitalization, domestic equity accounts are common stock, preferred stock, convertible securities, with the vast majority of holdings in common stock. In distinction to mid and small capitalization portfolios, which are described below, large capitalization domestic equity portfolios will primarily invest in stocks with market capitalizations (current market price per share times the number of common shares outstanding) consistent with its underlying performance benchmark (the Russell 1000). The vast majority of equity holdings will be in large capitalization issues.

Firm's that manage equity portfolios will continually monitor the risk associated with their equity investments. They will be expected to report on the active management decisions they have assumed relative to their respective benchmarks.

As a result of this risk/reward analysis, active equity managers will statistically attribute actual performance variance from their benchmarks in each regular

²A liquid security is one that has a readily available price, based either on a recent trade or a well recognized pricing mechanism. Such a security could be sold within one week at most, without incurring significant losses due to price depreciation, in a normal or typical capital market environment.

quarterly report. Included in this report will be statistics attributing performance to sector weighting decisions versus the benchmark and security selection decisions within each sector relative to the benchmark.

American Depository Receipts (ADR's) of foreign companies and foreign common stocks traded in U. S. dollars and on U. S. exchanges are authorized investments. ADR's and foreign common stocks traded in U. S. dollars and on U. S. exchanges should not exceed 15% of the portfolio. ADR securities that are 144A securities are authorized investments and cannot exceed 5% of the portfolio.

Derivative securities may not be held in domestic equity portfolios except to mitigate risk, on a temporary basis, of underlying portfolio holdings. Compliance with the previously stated derivatives guidelines must be met.

No single security can represent more than 5% of the market value of a portfolio at the time of purchase, and no single industry (based on Global Industry Classification System (GICS) codes) can represent more than 15% of the market value of the account.

4) Domestic Equity Portfolios - Mid Capitalization

The above restrictions and guidelines for large capitalization domestic equity portfolios also apply to mid capitalization domestic equity portfolios, except for the applicable benchmark related requirements. Mid capitalization, domestic equity portfolios will invest in stocks with market capitalizations consistent with its underlying benchmarks (the Russell Mid Cap Index).

5) Domestic Equity Portfolios - Small Capitalization

The above restrictions and guidelines for large capitalization domestic equity portfolios also apply to small capitalization domestic equity portfolios, except for the applicable benchmark related requirements. Small capitalization, domestic equity portfolios will invest in stocks with market capitalizations consistent with its underlying benchmarks (the Russell 2000, Russell 2000 Growth or Russell 2000 Value).

Investments in equity securities that are not rated by nationally recognized rating agencies are acceptable for small capitalization equity managers. Typically, stock rating agencies require 10-year dividend and earnings track records to produce equity security ratings. Given that many small capitalization equity securities typically do not have 10-year dividend and earnings track records, it is expected that a majority of small capitalization equity holdings will not have stock ratings.

6) International Equity (Large & Small Cap) Portfolios - Developed & Emerging Markets

Assets in international equity portfolios will be primarily composed of foreign ordinary shares and ADR's (including ADR's that are 144A securities). Short term, high-grade fixed income securities may be purchased as previously stated, similar types of securities denominated in foreign currencies may be purchased, or

the Fund's custodial sweep account may be employed. International equity portfolios will invest in stocks with market capitalizations consistent with their underlying benchmarks (large cap international-MSCI EAFE Index, and small cap international-MSCI EAFE Small Cap Index). Emerging market equity portfolios can invest in stocks with large, mid and small market capitalizations. Firms will continually monitor the country, currency, sector and security selection risks associated with their international and emerging market equity portfolios. All of the risks will be included in the manager's quarterly reports and performance attribution based on these factors will also be included. Currency hedging, consistent with the previously stated derivative policy, is an acceptable investment activity. However, prior to initiating such hedging activities, the firms must adequately demonstrate their capability and expertise in this area to the Board.

Large capitalization international equity portfolios will be measured against a reasonable version of the MSCI EAFE Index (Europe, Australia, and the Far East). Small capitalization international equity portfolios will be measured against the MSCI EAFE Small Cap Index. Emerging market equity portfolios will be measured against the MSCI Emerging Market Index. If the manager feels another index is more appropriate, this case should be made in writing to the Board.

7) Private Equity Fund of Funds

The private equity market is inefficient and illiquid due partially to privately negotiated, non-auction pricing mechanisms. High return premiums are expected by investors who are willing to accept the illiquid and inefficient characteristics of the private equity market. Therefore, the long-term expected return from private equity markets exceeds the expected return of public equity markets.

Controlling risk in the private equity portfolio is equally as important as seeking higher returns. Because private equity cannot measure risk in a traditional manner (using quantitative risk measures like standard deviation and benchmark tracking error), risk will be managed through a combination of quantitative and qualitative constraints, such as diversification of investment type and thorough due diligence.

To strengthen diversification of the investments, private equity fund of funds are the primary focus. This approach employs active systematic identification of excellent partnerships. The criteria used to develop partnership allocations will consist of (and not be limited to) geographic location, industry investment orientation, financial funding stage orientation, source of deal flow, and investment size.

Performance will be reported on a vintage year internal rate of return (IRR) basis. Internal rate of return is a total dollar weighted rate of return where the discount rate equates the net present value (NPV) of an investment's cash inflows with its cash outflows. Vintage year is the year of fund formation and first takedown of capital. The long-term objective is to outperform the benchmark, net of

investment management fees, calculated on an IRR basis over rolling ten-year periods.

Asset allocation is a critical driver for the long-term success of the private equity program. To control asset allocation risk, investments are diversified through four long-term subclass parameters:

Leveraged Buyouts/Corporate Finance: the acquisition of a product or business that is typically further along the business life cycle, having relatively predictable cash flows and the ability to raise capital utilizing a significant amount of debt and little or no equity. The expected return is 15-25% with a moderate risk level.

Venture Capital: targets companies in the earliest phases of a business cycle. Companies may be classified as seed, early, middle and late stage. These companies have uncertain revenues and a need for cash to build their businesses and are subject to high failure rates. Expected return is 20-30% with a high risk level.

Special Situations: includes investments in distressed debt, mezzanine, sector, opportunity, and secondary funds. Expected return is 15-25% with a moderate risk level.

Geography/Domestic vs. Global: investments either made in the United States or investments made outside of the U.S. including Europe, Asia, and Canada.

Risk will also be controlled by liquidity, vintage year, investment managers, firm, time and geographic and economic region.

Liquidity risk is managed by minimizing the possibility of forced sales that may arise from exceeding maximum exposure limits or lowering asset allocation exposure limits. Exposure through a fund of funds will help minimize this risk.

Vintage year reflects the year of fund formation and first takedown of capital. Vintage risk refers to the variability of private equity commitments over time. A secondary investment is a vehicle in the special situation subclass that allows the portfolio to gain prior year vintage exposure, further minimizing vintage risk.

Manager risk consists of the exposure within a partnership and the number of general partners in the private equity portfolio. Most partnerships require minimum commitments, which help control the exposure of partnerships.

Firm risk is the amount of exposure to a private equity general partner. The maximum commitment to private equity will be 5-10% of the total fund.

Commitments will be made over the full course of the business cycle and will not be concentrated in any one year.

Geographic and Economic Region: In the selection of private equity investments, the portfolio will not favor particular economic or geographic regions. Most likely, the focus will be globally oriented.

Alignment of Interests

General partnership agreements will be actively negotiated. The partnership agreements will ensure that the interests of the general partner are aligned with the limited partners.

8) Domestic Fixed Income Portfolios

Acceptable security types for domestic fixed income portfolios are certificates of deposit, commercial paper, other high grade short-term securities, U. S. Government and Agency securities, corporate bonds, mortgage- and asset-backed securities³ and Yankee bond securities. In addition, taxable municipal bonds, commercial mortgages and trust preferred securities are acceptable security types.

Cash and equivalent holdings may be comprised of high grade certificates of deposit, commercial paper, U. S. Treasury bills and repurchase agreements.

Firm's that manage fixed income portfolios will continually monitor the risk associated with their fixed income investments. They will be expected to report on their active investment management decisions they have assumed relative to their respective benchmarks. As a result of this risk/reward analysis, active fixed income managers will seek to statistically attribute actual performance variance from their benchmarks in each regular quarterly report. Statistics which relate performance variance to effective duration decisions, yield curve positioning, sector allocation, security selection and other portfolio management decisions will be included in each quarterly report. Also, to the extent possible, various interest rate scenarios will be depicted in horizon analysis testing, with time horizons spanning the next six months to one year, or longer.

Derivative securities may be held in domestic fixed income portfolios according to the guidelines previously stated. A measurement of the risk⁴ associated with the derivative security must be provided in writing and explained to the Board.

³ Please note that convertible debt, traditional zero coupon bonds, mortgage-pass through securities and asset-backed securities are technically derivative securities but for the purposes of this Policy Statement these securities are not classified as derivatives. Such investments must be at least BBB rated and meet the risk requirements discussed in the subsequent footnote.

⁴ An example of an acceptable risk measurement tool is the bond Flow Uncertainty Index (FLUX) scores. Under this risk scoring system, acceptable individual issues must have a FLUX score of 15 or less. The FLUX score measures the cash flow certainty of a bond using seven interest rate scenarios, such as interest rates: 1) Rise by 300 basis points over a three-year period; 2) Rise by 150 basis points over a one-year period; 3) Remain the same; 4) Decline by 150 basis points over a one-year period; 5) Decline by 300 basis points over a three-year period; 6) Rise by 150

No more than 5% of an investment manager's fixed income portfolio may be invested in below investment grade rated securities (BB or B rated bonds). No security rated below single B may be purchased at any time. Therefore, at least 95% of the manager's fixed income portfolio must be invested in investment grade securities. An investment grade security is defined as a security which has been rated investment grade (BBB rated or higher) by at least one (but preferably two) of the three nationally recognized rating agencies,⁵ preferably with such rating provided by Standard & Poor's or Moody's. The intent of this guideline is to require domestic fixed income managers to invest in investment grade securities. This investment grade requirement does not mean that domestic fixed income managers should not attempt to enhance portfolio returns by specifically purchasing split-rated securities (bonds that have both investment grade and non-investment grade ratings). Therefore, split-rated investments can be purchased if they are expected to be upgraded to investment grade ratings.

Securities that have at least single B ratings but subsequently fall below single B ratings, based upon the ratings of nationally recognized rating agencies, shall be sold in an orderly manner. Overall bond portfolio quality ratings shall be high, as determined by the quality ratings of nationally recognized rating agencies.

As mentioned above, investments in Yankee bond securities (U.S. dollar denominated international bonds that are registered with the Securities & Exchange Commission) are an acceptable investment.

No single security can represent more than 5% of the market value of a portfolio at the time of purchase, and no single industry (based on Global Industry Classification System (GICS) codes) can represent more than 15% of the market value of the account. These single security and single industry restrictions do not apply to U. S. Government and Agency bond holdings.

a. Rule 144A Securities

Rule 144A allows debt which is unregistered with the SEC to be traded in the U.S. securities markets with some restrictions. Only investors with \$100 million under management may purchase Rule 144A securities. This

basis points over a one-year period and then decline 300 basis points over the subsequent two-years; and, 7) Decline by 150 basis points over a one-year period and then rise 300 basis points over the subsequent two-years. Assuming certain prepayment rates as developed by the Public Securities Association, FLUX scores represent an evaluation of the present value of cash flows that a bond will generate under the above interest rate scenarios, plus a measure of yield volatility. FLUX scores have been developed for CMO's (collateralized mortgage obligations) and MBS's (mortgage backed securities).

⁵ The three nationally recognized rating agencies are Standard & Poor's, Moody's, and Fitch Investors Service, Inc.

is called the “Qualified Institutional Buyer” restriction and is designed to protect the common investor from purchasing bonds without sufficient information. Rule 144A bonds are issued in the same syndicate process as registered debt. Typically, the Rule is used by investment grade Yankee issuers (foreign-domiciled entities that issue U. S. dollar denominated fixed income securities), although domestic issuers have also begun to issue this type of debt to escape the high costs and complexities of SEC registration.

Rule 144A securities have become more accepted by institutional investors and are more liquid than in the past. Typically the reason for holding such securities is higher expected returns. Currently, these securities represent 2% of the Barclays Aggregate Index. Based upon these facts, each bond portfolio may hold up to 20% of assets in Rule 144A bond issues.

9) High Yield Fixed Income

The Association has approved a dedicated below investment grade asset allocation target. The same fundamentally-based research effort required of domestic fixed income managers is also required of high yield fixed income managers. The goal of the high yield allocation is to generate high total returns, while investing across the full maturity spectrum of corporate securities. Proper diversification of high yield portfolios is required, such that reasonable risk/reward expectations are maintained. Performance attribution is required, as is the case of domestic fixed income managers. With respect to future performance patterns, it is anticipated that high yield fixed income managers will provide significant down-side protection, while attaining reasonable up-side returns. The portfolio will primarily invest in BB and B rated securities, but may allocate up to 20% in CCC-rated securities. All other requirements of domestic fixed income managers apply to high yield fixed income managers.

10) Treasury Inflation Protected Securities

The Association has also approved a dedicated TIPS asset allocation target. An active investment approach will be taken toward the management of TIPS portfolios. The same fundamental and valuation-based research effort required of domestic fixed income managers is also required of TIPS managers. The goal of the TIPS allocation is to protect against inflation. Proper diversification of TIPS portfolios is required, such that reasonable risk/reward expectations are maintained. Performance attribution is required, as is the case of domestic fixed income managers. All other requirements of domestic fixed income managers apply to TIPS portfolios.

11) Real Estate Portfolios

The above restrictions and guidelines for large and small capitalization domestic equity portfolios also apply to Global REIT portfolios, except for the following differences. Investments are expected to be primarily in common stocks. A small percentage (less than 10%) may be in preferred stock. No restrictions exist on the market capitalization of Global REIT portfolio holdings. In addition, the Global REIT benchmarks may have individual security market capitalization weights greater than 5%. As a result, individual security positions in Global REIT portfolios may generally reflect the weights in the underlying benchmarks. (It may be that the Association's Global REIT commitment could be in a commingled fund, and that the Association would have to accept the investment guidelines of the Global REIT fund.)

While global REIT securities are recognized to have real estate and small cap security characteristics, global REIT security portfolios are primarily viewed as an alternative to direct real estate investments or real estate operating companies. These securities also have a higher level of liquidity than direct real estate investments and this is considered a favorable attribute. As such, there is a desire to maintain the favorable liquidity attributes of these securities and not to become over-concentrated in individual portfolio holdings.

In addition to real estate securities, the Retirement Association has directly invested in real estate through an open-end real estate fund. The objective of the fund is to outperform domestic real estate market, as measured by the NCREIF ODCE Index, the Open End Diversified Core Equity Real Estate Index, which is comprised of large open-end domestic real estate funds. Diversification will be obtained both through property type and geographical location. It is expected that investments will be primarily in large metropolitan centers. Relatively conservative levels of debt financing will be used in the purchase of real estate properties and modest investments in value-added real estate opportunities will be made. Property valuations will be conducted so as to reflect realistic economic value at quarter-end periods.

5.5 Watch List Investment Policy

Purpose of Watch List

In order to more officially monitor and track existing and potential problems at the fund/ portfolio management and company levels, the Board has adopted the following "watch list" investment policy. The watch list has been instituted to specifically monitor portfolios, exclusive of private equity investments, on both quantitative and qualitative factors. The purpose of such a list and its procedures is to identify how performance and other organizational issues will be monitored and how they will be responded to in a timely manner.

Quantitative Screens

The quantitative portion of the watch list will be primarily focused on performance of the fund vs. the appropriate benchmark and peer group. The proposed guidelines for equity and fixed income portfolios or funds are provided below.

Equity & Global REIT Portfolio Monitoring

Each equity portfolio and commingled fund participation will be evaluated according to four benchmarks and over the short- and possibly long-term time periods listed below. These benchmarks are:

- 1) Market index: Achieve at least 90% of the index return
- 2) Asset class median: Exceed the median equity manager/fund return
- 3) Median risk-adjusted return within the asset class: Exceed that of the median manager/fund
- 4) Investment style group: Exceed the median investment manager/fund return.

Fixed Income Portfolio Monitoring

Each fixed income portfolio and commingled fund participation will be evaluated according to three benchmarks. These benchmarks are:

- 1) Market index: Achieve at least 95% of the index return
- 2) Asset class median: Exceed the median fixed income manager/fund return
- 3) Median risk-adjusted return within the asset class: Exceed that of the median manager/fund.

Qualitative Factors

In addition to the performance screens, several other factors relating to the portfolio/fund's management and style will be continually monitored. These factors are:

1. The portfolio's fundamental investment characteristics vs. the appropriate market index (benchmark)
2. The portfolio's ability to adhere to its stated investment style
3. Continuity of the portfolio management and analytical research staff members
4. Continuity of firm's senior management and organizational structure
5. Regulatory developments.

Data Screens

Quantitative

Performance net of fees will be compared to the above-mentioned benchmarks over a short-term and long-term basis. The time horizon for the short-term period will be the trailing 12 months, as of each calendar quarter-end. For the longer-term period, each of the top four benchmarks will use a 3- to 5-year period to evaluate compliance with the benchmark. As data begins to exceed the 3-year period, data over the longest time period up to 5-years will be used. For the final benchmark, the manager's investment style group, the long-term period is the past two-year period.

If over the short-term period an equity investment manager/fund does not satisfy its investment benchmarks, the Board will send a letter to the investment manager specifying the short-term benchmarks that the manager has not been able to satisfy. Written explanation of the reasons for non-compliance with the manager's benchmark will be submitted to the Board and consultant. In addition, changes that will be made to correct this situation will be stated in writing by the investment manager.

If a manager is not in compliance with its performance benchmarks over the long-term period, the Board will place a discussion item on its agenda to evaluate alternative courses of action.

Qualitative

With regards to the qualitative factors, deviation from any of the factors under consideration will immediately lead to the fund/portfolio being placed on the watch list, put on the Board's next meeting agenda, and will be discussed at the next Board meeting. The fund/portfolio will be monitored on an ongoing basis.

The Board reserves the right to take any action with respect to its investment managers at any time. The watch list policy does not restrict the Board from any action.

Action Steps by the Board

Funds/portfolios that are placed on the watch list will be monitored quarterly for improvement or deterioration. Funds/portfolios may remain on the watch list for a maximum period of three calendar quarters. After three quarters, the fund/portfolio will either be removed from the watch list or moved to the probation list. If the fund/portfolio does not come back into compliance with the policies during this time, a decision will be made regarding the fund's/portfolio's future viability in the Plan structure. If the Board does not feel that the fund/portfolio is a viable option, a replacement search will be initiated by the consultant.

Watch List Action Overview

Status	Period	Purpose	If no improvement...
Discussion	Any time	Discuss portfolio issues	Move to Watch list
Watch	Nine months	Monitor for improvement	Move to Probation list
Probation	Any time*	Conduct firm/team analysis	Initiate replacement

*The probation period will be determined on a case by case basis.

PART IV
CONTROLS

6.0 SECURITIES LENDING

Based upon a thorough review of the custodian's securities lending program, including indemnification and fiduciary responsibility issues, the Board has decided to participate in securities lending. The following controls apply to the securities lending program.

- 6.1** The Master Custodian will manage a securities lending program to produce incremental income in accordance with the terms and conditions set forth in a mutually acceptable securities lending agreement.
- 6.2** The Board reserves exclusive authority to approve the securities lending agreement prior to the commencement of securities lending activity.
- 6.3** Unless otherwise specified in the agreement(s),
- a. All loans shall be marked-to-market daily
 - b. Minimum collateral on each loan shall be maintained daily at 102 percent of loan value for domestic securities and 105 percent of loan value for international securities
 - c. Acceptable collateral shall be in the form of cash or marketable fixed income securities with maturities not greater than one year, including: (1) Commercial Paper or Variable Rate Notes of issuers with quality ratings of P-1 and/or A-1 by Moody's Investors Services or Standard & Poor's Corporation, or their equivalents; (2) Banker's acceptances, certificates of deposits and time deposits; (3) United States Treasury and Government Agency short-term obligations; (4) Repurchase Agreements with United States Treasury Securities and Agencies of the United States Government as collateral; and, (5) Money or short-term investment funds.
 - d. If rated, borrowers shall be rated AA, Aa or higher by Moodys or Standard & Poors.
- 6.4** The securities lending agent will report on an annual basis, the following information to the Association:
- a. The list of approved security borrowers. Also a list of those dropped from the program over the past year.
 - b. A description of the evaluation process used when considering potential security borrowers. A list of borrowers that defaulted in the past year.
 - c. Explanation of any changes to the securities lending process over the past year.
 - d. A description of how the securities lending agent manages the asset/liability relationship of the lending program

- e. How the securities lending queue is managed to produce equitable revenue for all the participants.

On a monthly basis the securities lending agent shall report the following information to the Association:

- a. The percentage of securities on loan by asset class, revenues generated by asset class and the net basis points earned on the program
- b. A comparison of the data in sub-section 6.4 a. above to the past month shall be made.

6.5 The Retirement Administrator, in conjunction with the investment consultant, shall be responsible for monitoring the securities lending program and recommending changes as appropriate.

7.0 PROXY VOTING

Developments in the equity markets have caused a heightened awareness of investment managers' proxy voting policies. In addition, the SEC has recently required mutual funds to report their proxy voting decisions to fund investors. The desire of certain investors to make sure the mutual fund companies are remaining objective in their evaluation of corporate activity has created the desire for higher proxy voting visibility.

While these SEC requirements do not directly apply to separately managed institutional portfolios, the Board expects no lesser reporting disclosure from its investment managers, regardless of the form of the account. The Board reaffirms its commitment to its proxy voting policy and directs its investment managers to remain vigilant in its evaluation of corporate actions. Managers must be thorough and objective in their evaluation of proxy voting issues. The Association's investment managers must demand the highest degree of integrity from corporate managements represented in the Association's portfolios. If the Association's managers are found to be in favor of corporate managements to the disadvantage of the Association, the manager will be terminated. Finally, the Board expects a high degree of accountability and objectivity from its managers with respect to proxy voting. Areas that the Board will closely monitor include employee stock options, management compensation, and the level of external directors on Boards and various management committees.

7.1 As previously stated, the Board's primary objective is to have their proxy ballots voted according to the best economic interest of the Association's members. If the Board decides to delegate to their investment managers the responsibility for voting proxy ballots, the investment managers agree to classify and report on the Association's proxies according to the following generic categories:

- 1) Routine business or financial matters
- 2) Non-routine business or financial matters
- 3) Anti-takeover issues
- 4) Corporate governance shareholder proposals

5) Social responsibility shareholder proposals

7.2 Under normal circumstances, it is expected that the investment managers will employ the Board's following proxy voting guidelines on issues of routine business or financial matters. The managers will vote for:

- 1) The proposed slate of directors, assuming directors attend requisite meetings
- 2) Appointment of auditors
- 3) Increases in authorized common stock, not to exceed 100% of existing authorized shares
- 4) Changes in board structure

7.3 The Board also provides the following general guidelines with respect to non-routine matters, anti-takeover issues, corporate governance proposals and socially responsible proposals:

- 1) For issues that involve non-routine business or financial matters, the managers would be expected to vote against the nonfinancial effects of a merger proposal, but for director liability and indemnification, stock option plans and stock splits.
- 2) In the area of anti-takeover issues, it is expected that the investment managers shall vote against blank check preferred stock proposals, classified boards, limiting shareholders' right to call special meetings, limiting shareholders' rights to act by written consent, super-majority voting requirements, reincorporation proposals, issuance of stock with unequal voting rights and elimination of preemptive rights.
- 3) With respect to corporate governance shareholder proposals, the managers will be expected to vote for requiring a majority of independent directors, submitting a company's shareholder rights plan to a shareholder vote, implementing confidential voting, anti-greenmail proposals, opting out of State anti-takeover laws, equal access to proxy materials, submitting golden parachutes to a shareholder vote, adopting cumulative voting and shareholder proposals involving anti-takeover proposals. The managers will be expected to vote against limiting the terms of directorship and stock ownership requirements.
- 4) In the area of socially responsible shareholder proposals, the managers will vote these proxies in the best economic interest of the Association's members.

7.4 Under certain circumstances, the Board recognizes that voting in accordance with these issue-specific proxy guidelines will not be consistent with their primary proxy voting guideline of voting all proxy ballots according to the best economic interest of the Association's members. In such cases, when reporting to the Board in their regular quarterly report, the investment manager shall explain why they did not vote according to the Board's issue-specific proxy guidelines.

On a quarterly basis, the investment managers shall provide to the Board the following information on their proxy votes:

Company Name	Date of Vote	Proxy Issue	Vote

8.0 TRANSACTIONS, BROKERAGE, AND COMMISSION RECAPTURE PROGRAM

The Board understands their fiduciary responsibility with respect to transactions and hereby instructs their investment managers to seek best execution when conducting all trades. Managers are instructed to seek to minimize commission and market impact costs⁶ when trading securities. Also, either internally or through an externally provided transaction cost evaluation service, investment managers are expected to measure the costs associated with their investment trades.

Investment managers shall provide quarterly reports to the Board summarizing commission activity by broker, indicating the average commission cost and execution costs. (To the extent that execution cost data on the Association's portfolio is available, it should be reported. If data on the Association's portfolio is not available, report overall firm execution cost information.) While there are many ways of measuring execution costs, same day, and volume weighted average prices will be used to calculate these costs.

Volume weighted average price equity execution costs are defined as the purchase price less the volume weighted average price on the trade date, and the volume weighted average price on the trade date less the sale price.

When trading securities, best execution is the paramount consideration of the Board. This objective is expected to provide for and protect the best economic interest of the Association. As part of the trading process, managers shall determine expected trading costs associated with the Board's commission recapture brokerage firms. If trading through these brokerage firms is in the best economic interest of the Association, the managers are expected to consider these firms as well as others in obtaining best execution.

For example, if an equity trade is contemplated and an investment manager can execute the trade through the Board's commission recapture brokerage firm while not incurring any incremental commission or market impact costs, then the Board would like the manager to do so. However, if a manager is required to carve out a portion of a block

⁶ Market impact for equity trades is based on the transaction price relative to the volume weighted average price (VWAP) on the trade date. With the expansion of greater trading volume near the close of the market, transaction prices are also evaluated relative to same day closing prices.

trade to accommodate a trade through the Board's directed trading brokerage firm or if such a trade is likely to lead to increased costs, the manager shall not trade through the Board's commission recapture brokerage firm.

All securities transactions shall be executed through reputable member-firm broker/dealers.

9.0 PORTFOLIO REPORTING REQUIREMENTS

In addition to the derivatives, portfolio and quarterly proxy reporting requirements stated in the previous section, reports to the Board shall include the following information and cover these stated topics:

9.1 Quarterly Reports:

- 1) Portfolio investment objectives, investment strategy and decision making process:
The investment objectives of the portfolio will be clearly stated. Next, a narrative description of the portfolio's investment strategy will be provided, with a discussion of the factors that proved to be favorable and those that were unfavorable. In addition, a concise statement of the firm's investment decision making process will be provided and any changes or modifications that were made to the process.
- 2) Portfolio performance before and after investment management fees:
The manager shall report the quarterly total portfolio rate of return before and after investment management fees have been deducted, as well as cumulative and annual performance on both bases since account inception. Also included in these tables will be the manager's performance benchmarks.
- 3) Portfolio asset mix and asset growth:
The portfolio's allocation to the major asset classes will be specified for the beginning and end of the quarter. Market values will be shown for the total account over the same period.
- 4) Portfolio allocations according to characteristics and other classifications:
Specific portfolio characteristics will be developed and contrasted to those of the portfolio's performance benchmark. In addition other sector and industry comparisons will be provided.
- 5) Portfolio reconciliation to the custodial bank:
As of quarter end, the manager will reconcile their portfolio market value to that provided by the Association's custodial bank. The Association's custodial trustee accounts for investments on a trade date, full accrual basis. Explanation of discrepancies shall be provided.
- 6) Portfolio positions and transactions:
Individual issues in the portfolio as of the most recent quarter-end shall be

provided, as well as a list of portfolio purchases and sales. Securities that are sold will be classified according to the manager's general reasons for sale.

7) Derivatives report:

As stated in the derivatives section, on an annual basis risk analysis will be provided, as well as the other reporting requirements listed in that section.

8) Portfolio Investment Guidelines

As stated in the previous section entitled Investment Manager Guidelines, portfolio characteristic reporting is discussed, as well as attribution analysis reporting requirements. These characteristics and attribution analysis will be included in the managers' quarterly reports. Payment of any placement agent fees will be stated and explanation of this policy violation will be provided.

9.2 Monthly Reports:

1) Portfolio summary report and detailed positions and transactions.

A summary report consisting of a statement of changes in market value from the preceding month, a summarized portfolio composition using market values and portfolio performance for the latest month, and a portfolio reconciliation to the custodial market value of the account. The report should also include individual issues in the portfolio as of the most recent month-end along with a list of portfolio purchases and sales.

10.0 BOARD REVIEW & DUE-DILIGENCE TRAVEL POLICY

The Board will conduct the monitoring of investment performance and manager structure. On a monthly basis, the Board will review monthly investment reports, investment strategy, market conditions, portfolio manager performance and the status of the Association's asset allocation plan. The Board will meet the Association's investment managers once every 18 months. On-site due diligence visits will be scheduled with a portion of the Association's managers on an annual basis.

Providing ongoing oversight of the investment management firms selected to invest the Association's assets is an important component of the fiduciary duty of prudent investment. This oversight involves not only monitoring investment performance, but also includes: (1) Understanding the reasons for positive or negative performance; (2) Assuring consistency in the investment process and philosophy utilized in managing the portfolio; (3) Monitoring the organizational structure and financial stability of the firm; (4) Staying abreast of any regulatory actions or litigation involving the firm; (5) Monitoring the firm's increase or decrease in assets under management; and (6) Obtaining any other information that is relevant and material to understanding the firm's management of the Association's assets. Conducting periodic on-site due diligence meetings with investment managers is an excellent method for addressing these oversight responsibilities and for assuring that the continued engagement of a particular investment management firm is

prudent and in the best interests of the Association. Accordingly, the Association will endeavor to perform a minimum of two on-site due diligence visits with investment managers per year. Such on-site due diligence meetings will focus on in-depth manager-specific issues relevant to the engagement and a report on the meeting will be presented to the Association's Board. Additional on-site due diligence visits may be undertaken if warranted by circumstances or developments with an investment management firm.

There will be a regular quarterly review of investment manager performance versus the respective investment manager's guidelines and benchmarks. Performance both before and after investment management fees will be evaluated. Investment results over periods extending back five years or since inception will be stated if available, as well as the appropriate universe medians and style group comparisons by the Association's investment consultant.

Explanations will be provided by the investment consultant as to why portfolios under or outperformed their respective benchmarks. Performance attribution will be provided to the extent possible. Also, risk-adjusted performance will be evaluated.

11.0 POLICY EXCEPTIONS

While this Policy prescribes various maximums, minimums and other relatively arbitrary numerical limits, it is intended primarily to be a management tool. When the Board determines that an exception to one of the numerical limits here within is in the best interest of the Association, such exception is permitted as long as it is consistent with applicable County Employees' Retirement Law of 1937, State, and Federal laws.

Whenever an exception or violation of this Policy is discovered, that fact shall be reported to the Retirement Administrator and the Board Chairman within one business day of its discovery and major exceptions will be reported immediately.

12.0 POLICY REVIEW

This investment policy shall be reviewed annually to ensure the Association's compliance with the overall objectives of safety, liquidity and investment performance, and current laws and financial trends. Proposed amendments to the Policy shall be prepared by the Association's consultant and shall be presented to the Board for consideration and approval.

13.0 GRANDFATHER CLAUSE

Any investment held by the Association at the time this policy is adopted or amended shall not be sold to conform to any part of this policy unless its sale is judged to be prudent by the Board in consultation with the Association's investment professionals.

14.0 PORTFOLIO REBALANCING

- 14.1** The consultant shall monitor the portfolio regularly and report to the Board not less than quarterly on the advisability of rebalancing the portfolio.
- 14.2** In monitoring the portfolio, the consultant shall be guided by the target asset allocation ranges for each asset class in Appendix C. The Board shall also establish acceptable asset allocation ranges for each of the Association's investment managers.
- 14.3** The Board has authority to issue instructions to managers to liquidate securities for reallocation to other managers or other asset classes, but shall do so only after considering the recommendation of the Retirement Administrator and investment consultant.
- 14.4** All interest, dividends, net operating revenue and capital gains shall be reinvested by the investment manager accountable for the underlying security investment.
- 14.5** The Retirement Administrator, in conjunction with the Investment Consultant, shall prorate net positive cash flows to asset classes that have fallen beneath their target allocation and are approaching the minimum allocation level. The proration shall take into account the asset class' percentage of the total portfolio and the magnitude of the deviation from the target.
- 14.6** When all asset classes are within 2 percent of the target allocation, the Retirement Administrator shall prorate net positive cash flows to each asset class on a rotating basis in order of the asset class' percentage of the total portfolio.
- 14.7** The Board shall review the allocation of assets to each investment manager as part of the Board's asset allocation review.
- 14.8** On an annual basis, the Retirement Administrator shall develop a cash flow plan for the subsequent year. This plan will take into consideration expected cash needs both for the payment of benefits as well as to fund under-allocated or new asset classes.

15.0 RESPONSIBILITIES OF GLOBAL CUSTODIAN

The Board recognizes that accurate and timely completions of custodial functions are necessary for the effective monitoring of the investment management activity. The custodian's responsibilities for the Association's investable assets are to:

- 15.1** Provide complete global custody and depository services for the Association's designated accounts.
- 15.2** Provide a Short Term Investment Fund (STIF) for investments of any cash, to ensure maximum investment of the Association's assets.
- 15.3** Provide in a timely and effective manner, settlement of securities transactions and provide monthly reports of the investment actions implemented by the Association's investment managers.
- 15.4** Collect all income and principal realizable and properly report the collections on the custodial periodic statements.

- 15.5 Provide monthly and fiscal year-end accounting statements for the Association's portfolios, including all transactions. These statements should be based on accurate security values both for cost and market. These reports should be provided within an acceptable time frame.
- 15.6 Report to the Association situations where accurate security pricing, valuations and accrued income is either not possible to report or is subject to considerable uncertainty.
- 15.7 Provide assistance to the Association to complete such activities as the annual audit, transaction verification or unique issues as required by the Board.
- 15.8 Effectively manage a securities lending program for the Board.
- 15.9 Provide electronic access to accounting report systems. Track securities litigation cases of past and current investments made by the Association's investment managers. Provide periodic securities litigation reports.

16.0 RESPONSIBILITIES OF INVESTMENT CONSULTANT

- 16.1 Work with the Board and Staff to manage the investment process.
- 16.2 Review of asset allocations and performance in conjunction with the Staff and make recommendations to the Board as appropriate.
- 16.3 Assistance with external money managers selection; promptly inform the Board and discuss the impact of material changes taking place within any current manager's investment process.
- 16.4 Meetings with the Board to provide an independent perspective on the Fund's goals, structure, performance and managers.
- 16.5 The standard of prudence applied to the external investment consultant shall be the *Prudent Person Standard* and shall be applied in the context of managing an overall portfolio.
- 16.6 The external investment consultant will acknowledge in writing that he/she is a fiduciary of the pension plan.
- 16.7 Investment Consultant will provide the Retirement Association with quarterly reporting and commentary on total portfolio performance, performance by asset class, and individual manager performance.

APPENDIX A

DERIVATIVE DEFINITIONS

A.1 DERIVATIVES

The following derivative definitions are taken from the ICI Memorandum on Fund Investments in Derivatives:

- 1) **"Options:** An option represents the right to buy or sell an underlying asset (often, a security) at a specified time for a specified price. A call option is a right to purchase the underlying asset; a put option is the right to sell it. A fund that buys options has the right to buy or sell the underlying asset. A fund that writes (i.e. sells) options are obligated to sell the underlying asset to, or buy it from, the party that purchased the options (if that party "exercises" the option). A fund that writes an option is paid a premium for doing so. Options can be either standardized or customized and privately negotiated. Some are exchange listed and others are traded over-the-counter.
- 2) **Forward Contracts:** Funds may enter into forward contracts, which obligate the fund and its counterparty to trade an underlying asset (commonly, foreign currency) at a specified price at a specified data in the future. Forward contracts are traded in the over-the-counter markets.
- 3) **Futures:** Futures are similar to forward contracts, but differ in that they are standardized and traded on a futures exchange. Unlike forward contracts, the counterparty to a futures contract is the clearing corporation for the appropriate exchange. Futures are typically settled in cash, rather than requiring actual delivery of the instrument in question. Perhaps the best known futures contracts are those involving the S&P 500. Parties may also buy or write options on futures.
- 4) **Swaps:** Swaps are over-the-counter transactions that involve two parties exchanging a series of cash flows at specified intervals. In the case of an interest rate swap, the parties exchange interest payments based on an agreed upon principal amount (referred to as the 'notional principal amount'). Under the most basic scenario, Party A would pay a fixed rate (e.g., 6%) on the notional principal amount (e.g., \$10 million) to Party B, which would pay a floating rate (e.g., LIBOR) on the same notional principal amount to Party A. (Typically, payments between the parties would be netted out and settled periodically.)

In recent years, the swaps market has grown dramatically, both in terms of size and variety. For example, interest rate swaps can involve cross-market payment (e.g., short-term rates in the US vs. short-term rates in the UK) and cross-currency payments (e.g., payments in dollars vs. payments in yen). Floating rate payments may be subject to caps (i.e., ceilings, floors) or collars (i.e., caps and floors together).

- 5) **Structured Notes:** Structured notes are over-the-counter debt instruments where the interest rate and/or the principal are indexed to an unrelated indicator (e.g., short-term rates in Japan, the price of oil). Sometimes the two are inversely related (i.e., as the index goes up, the coupon rate goes down; inverse floaters are an example of this) and

sometimes they may fluctuate to a greater degree than the underlying index (e.g., the coupon may change twice as much as the change in the index rate).

Structured notes are often issued by high-grade corporate issuers. There is often an underlying swap involved; the issuer will receive payments that match its obligations under the structured note (usually from an investment bank that puts the deal together) and, in turn, makes more 'traditional' payments to the investment bank (e.g., fixed rate or ordinary floating rate payments). It is important to note, however, that in such cases the mutual fund would not be involved in the swap; the issuer of the note would remain obligated even if its counterparty defaulted.

- 6) **Mortgage-Backed Securities:** The term 'mortgage-backed securities' encompasses a broad array of instruments with differing characteristics. Some of these instruments often are referred to as 'derivatives.' One such example is stripped mortgage-backed securities, which represent interests in a pool of mortgages, the cash flow of which has been separated into its interest and principal components. Interest only securities (IOs) receive the interest portion of the cash flow and principal only securities (POs) receive the principal portion. These securities may be issued by US government agencies or by certain private issuers. Their values are highly sensitive to the rate of mortgage principal prepayments, which tends to increase as interest rates fall and decrease as interest rates rise. When interest rates decline and principal payments accelerate, the interest payment stream is reduced and the value of the IOs decreases. When interest rates are rising and prepayments are slower, the average life of POs increases and their value decreases."

The final definition is from JP Morgan Securities Inc., Capital Markets Product Development Group, dated June 7, 1996, as prepared by Simon R. Pszerno:

- 7) **Swaptions (Options of Swaps):** "Options on swaps are agreements between two parties, giving one party (the buyer of the option) the right and the other party (the seller of the option) the obligation to, within a specified period of time, either 1) begin the exchange of payments of an interest rate swap (a 'contingent' swap) or 2) terminate the exchange of payments of an existing interest rate swap (a 'cancelable' swap). As in all options, the buyer of the option pays a premium to the seller for the right to initiate or to terminate a swap. Contingent swaps and cancelable swaps can be exercised on the exercise date (a 'European' option) and during the exercise period (and 'American' option). The terms of the option on the swap, such as the amount of the fixed and floating payments, the exercise date or period, the payment dates, and the maturity of the swap, are all determined at the start of the transaction."

APPENDIX B

Compliance Monitoring Form

Merced County Employees' Retirement Association

In accordance with the Investment Objectives and Policy Statement adopted, and officially approved on, the following compliance worksheet will be completed on a quarterly basis by each of the Association's investment managers. These statements must be e-mailed to the Retirement Association's office and investment consultant no later than 10 days after the end of each reporting period. (3.7)

General Compliance Issues

1. Who is the firm's Certified Public Accountant? How long has this firm served in this capacity? If any recent changes have occurred, please explain the reasons for the change. Have there been any qualifications to the firm's recent audits?
2. Has the firm acted as a fiduciary and invested its entrusted assets for the sole benefit of the Association? (3.4) Yes/No: ____ If no, please explain.
3. Has the firm paid any placement agent fees? (3.7) Yes/No: ____ If yes, please explain.
4. Are the Association's market benchmarks in the respective asset class areas acceptable to the firm? (4.5) Yes/No: ____ If no, please explain.
5. Has the firm's insurance coverage's been sustained? (5.0) Yes/No: ____ If no, please explain.
6. Does the firm consider any of the Association's investment objectives unreasonable? (5.1) Yes/No: ____ If yes, please explain.

7. Have there been any past or are there any anticipated significant portfolio developments, major changes in firm ownership, organizational structure and personnel? (5.1) Yes/No: ___ If yes, please explain.
8. Have there been any changes in the firm's investment approach? (5.2 2) Yes/No: ___ If yes, please explain.
9. Does the Association's guidelines require your firm to manage the portfolio significantly differently than other similar portfolios? (5.2 3) Yes/No: ___ If yes, please explain.
10. Has there been any industry or regulatory disciplinary actions taken against the firm? (5.2 5) Yes/No: ___ If yes, please explain.
11. Have proxy ballots been voted in accordance with the best economic interest of the Association and in a manner consistent with the Board's proxy policies? (5.2 8) Yes/No: ___ If no, please explain.
12. For domestic equity managers, is the firm supporting the commission recapture program? (5.2 9) Yes/No: ___ If no, please explain.
13. Has your firm been named in a lawsuit regarding its securities trading activities? Yes/No: ___ If yes, please explain. Does your firm expect to receive a lawsuit regarding its securities trading activities? Yes/No: ___ If yes, please explain.
14. Has an individual at your firm violated the firm's internal trading policies? Yes/No: ___ If yes, please explain. Is this individual a current employee of the firm? Yes/No: ___
15. Have your procedures for monitoring internal trading policies changed in the past three years? Yes/No: ___ If yes, please explain.
16. Are there any portfolio losses attributable to internal trading policy violations that have been incurred by the Association? Yes/No: ___ If yes, please explain. Will the Association be reimbursed for these losses? Yes/No: ___ If no, please explain.
17. Has your firm recently conducted its own internal investigation of the firm's trading activities and procedures? Yes/No: ___ If yes, please state when the investigation was completed.

18. If an internal investigation of the firm's trading activities has been completed, please supply the Association with a summary of the key findings.
19. What remedial action, if any, has the firm taken as a result of this internal investigation? What future action is likely to be taken?

Derivative Investments

1. If the firm entered into a non-exchange traded derivative, were the general nature and associated risks of the counter-party fully evaluated? (5.3 5) Yes/No: ___ If no, please explain.
2. For non-exchange traded derivative transactions, were the counter-parties broker/dealers? (5.3 5) Yes/No: ___ If yes: Do the counter-parties have investment grade debt? Yes/No: ___ Are the counter-parties registered with the SEC and do they have net capital to protect against potential adverse market circumstances? Yes/No: ___ If no, please explain.
3. For non-exchange traded derivative transactions, were the counter-parties financial institutions (banks)? (5.3 5) Yes/No: ___ If yes: Do the counter-parties have investment grade debt? Yes/No: ___ Do the counter-parties have total assets in excess of \$1 billion, and significant net capital to protect against potential adverse market circumstances? Yes/No: ___ If no, please explain.
4. Is individual counter-party exposure well diversified? (5.3 5) Yes/No: ___ If no, please explain. What is the largest exposure to a single counter-party within the portfolio? Have there been any changes to the investment manager's list of approved counter-parties over the past month?
5. Are the investment purposes for derivative investments consistent with the four purposes stated in the Association's policies? (5.3 6) Yes/No: ___ If no, please explain. Has the firm developed any new purposes for derivative investments? Yes/No: ___ If yes, please explain.
6. List all limited allocation derivative investments individually and the percentage of the portfolio's assets represented by each investment. (5.3 7) State if the firm has evaluated the exposure to market value losses that can occur from each of these derivatives. Yes/No: ___ If

no, please explain. State if these derivative investments in total represent more than 5% of the portfolio's market value. If more than 5%, please explain.

7. State if any restricted derivative investments are held in the Association's portfolios. Yes/No: ____ If any are held, state the percentage of the portfolio's assets held in such derivatives and why the firm is not in compliance with the investment policies. (5.3 7)
8. For derivative investments with allocation limits, has the firm tested and measured these investments' sensitivities to changes in key risk factors? (5.3 8) Yes/No: ____ If no, please explain.
9. Have all derivative investments been made in a manner consistent with the derivative investment process specified in the policy statement? (5.3 9) Yes/No: ____ If no, please explain.
10. Specify security pricing sources used when developing portfolio market value exposures for limited allocation derivatives. (5.3 10 b.)
11. Provide a statement regarding the liquidity of the derivative investments. Provide a general statement discussing the legal and regulatory risks associated with the portfolio manager's investments in derivatives.
12. State if the legal and regulatory risk associated with portfolio derivative investments have changed over the past quarter. (5.3 10 h.) Yes/No: ____ If yes, please explain.

Investment Manager Guidelines

1. Are portfolio holdings well-diversified, and made in liquid securities? (5.4 1) Yes/No: ____ If no, please explain.
2. Has the firm engaged in short selling, use of leverage or margin and/or investments in commodities? (5.4 1) Yes/No: ____ If yes, please explain.

Cash & Equivalents

1. Does the firm directly invest in short term fixed income investments? Yes/No: ____ If yes, do the investments comply with the policies? (5.4 2) Yes/No: ____ If no, please explain.

Domestic Equity Portfolios (Large Mid & Small)

1. Please state the percentage of the portfolio held in each of the following types of securities: common stock; preferred stock; convertible securities; and, cash & equivalents. (5.4 3)
2. To what extent are portfolio holdings outside the respective benchmark for the portfolio? (5.4.3) Has this percentage declined from last quarter? Yes/No: ____
3. Specify the percentage of the portfolio that is invested in American Depository Receipts (ADR's) and foreign common stocks traded in U. S. dollars and on U. S. exchanges. (5.4 3) Also, specify the percentage of the portfolio invested in ADR securities that are 144A securities. If greater than 15%, explain why.
4. What is the largest percentage of the portfolio represented by a single security? (5.4 3) If any securities were above 5% at the time of purchase, please list and explain why.
5. Based on GICS codes, what is the largest percentage of the portfolio represented by a single industry? (5.4.3) Please specify all industries above 15%. For small cap portfolios, specify if any single industry allocations are greater than 25%. (5.4 4)

International Equity Portfolios Large & Small Cap - Developed & Emerging Markets

1. Specify the percentage of the portfolio held in each of the following types of securities: foreign ordinary shares; ADR's; cash & equivalents (foreign or domestic). (5.4 5)
2. Is the firm monitoring the country, currency, sector and security selection risks associated with its portfolio? (5.4 5) Yes/No: ____ If no, please explain.
3. Does the portfolio currently employ a currency hedging strategy? Yes/No: ____ Is the firm in compliance with the Association's derivatives investment policy? (5.3) Yes/No: ____ If no, please explain.

Private Equity Fund of Funds

1. Are the investments diversified by geographic location, industry, financial funding stage, source of deal flow and investment size? Yes/No: ____ If no, please explain.
2. Has performance been reported on a vintage year internal rate of return basis? Yes/No: ____ If no, please explain.

3. Has risk been diversified by investments in leverage buyouts/corporate finance, venture capital, special situations, geographic region (domestic and global)? Yes/No: ___ If no, please explain.
4. Has risk been controlled according to stage of liquidity, vintage year, and funds? Yes/No: ___ If no, please explain.
5. Have partnership agreements been aligned with limited partner interests? Yes/No: ___ If no, please explain.

Domestic Fixed Income Portfolios

1. State the percentage of the portfolio held in each of the following types of securities: certificates of deposit; commercial paper; other high grade short-term securities; U. S. Government and Agency securities; corporate bonds; mortgage- and asset-backed securities; and, Yankee bond securities. (5.4 6)
2. Is the firm monitoring its active investment management decisions relative to the Association's investment benchmark? (5.4 6) Yes/No: ___ If no, please explain.
3. Does the firm conduct horizon analysis testing? (5.4 6) Yes/No: ___ If no, please explain.
4. Are derivative investments in compliance with the Association's investment policies? (5.3) Yes/No: ___ If no, please explain.
5. What percentage of the portfolio is invested in securities below investment grade? (5.4 6) If more than 5%, please explain. Are the below investment grade bonds at least single B rated? If these securities are below single B, specify the percentage of the portfolio and why they are held.
6. Excluding U. S. Government and Agency bond holdings, did any individual bond issue represent more than 5% of the market value of the portfolio? Yes/No: ___ (5.4 6) Please specify. At the time of purchase, was there any single industry, based on NAICS codes, that represented more than 15% of the market value of the account. Please specify.
7. What percentage of the portfolio is held in Rule 144A securities? (5.4 6) If greater than 20%, please explain.

High Yield Fixed Income

1. Has the firm employed a fundamentally-based research effort? (5.4 8) If no, why not?
2. Has the firm invested across the full maturity spectrum of corporate securities? (5.4 8) If no, why not?
3. Has the portfolio been diversified so as to maintain reasonable risk/reward expectations? (5.4 8) If no, why not?
4. Has the firm provided down-side protection, while attaining reasonable up-side returns? (5.4 8) If no, why not?
5. Has the portfolio/fund been in compliance with the quality requirements? (5.4.9) If no, why not?
6. Has the firm maintained all other requirements of domestic fixed income managers? (5.4 8) If no, why not?

Treasury Inflation Protected Securities Portfolio

1. Has the firm employed an active TIPS approach? (5.4 9) If no, why not?
2. Has the firm employed a fundamental and valuation-based research effort? (5.4 9) If no, why not?
3. Has the portfolio protected against inflation? (5.4 9) If no, why not?
4. Has the firm maintained proper diversification of its TIPS portfolio such that a reasonable risk/reward expectation has been maintained? (5.4 9) If no, why not?
5. Has the firm performed portfolio performance attribution analysis? (5.4.9) If no, why not?
6. Have all other domestic fixed income manager requirements been maintained? (5.4 9) If no, why not?

Global REIT Portfolios

1. State the percentage of portfolio holdings in excess of 5%, based on current market value.

Signed by:

Dated:

APPENDIX C

ASSET ALLOCATION PLAN AND TARGET ASSET MIX

Based on the Association's asset allocation study and acceptance of the proposed target asset mix (as stated in the July 16, 2009 Asset Allocation Study report), and subsequently modified for the introduction of dedicated domestic mid cap equity and emerging markets equity, the following is the Association's target asset mix and allocation ranges. The Association will review its asset allocation position as needed or a minimum of once every three to five years.

	<u>Target Mix</u>	<u>Allocation Ranges</u>	
		<u>Minimum</u>	<u>Maximum</u>
Total Domestic Equity	29 %	24 %	34 %
Large Cap	19	16	22
Mid Cap	4	3	5
Small Cap	6	5	7
International Equity	20	16	24
Emerging Markets Equity	4	3	5
Private Equity	5	0	8
Domestic & Global Real Estate	8	6	10
Domestic Fixed Income	24	19	29
High Yield Fixed Income	5	0	8
Treasury Inflation Protected Sec.	5	0	10
Short-Term Investments	0	0	3

The market benchmarks for the above asset classes are as follows:

Large Cap Equity	Russell 1000 or S&P 500
Mid Cap Equity	Russell Mid Cap Index
Small Cap Equity	Russell 2000, Russell 2000 Growth or Value
International Equity	MSCI Europe, Australia, & Far East Index (EAFE)
Emerging Markets Equity	MSCI Emerging Markets Index
Private Equity	S&P 500 + 5%; Thompson Reuters Venture Economics All Private Equity Index and Cambridge Private Equity Index
Real Estate	NCREIF ODCE Property Index & FTSE EPRA/NAREIT Global Real Estate Index
Domestic Fixed Income	Barclays Capital US Aggregate Bond Index
High Yield Fixed Income	Merrill Lynch High Yield Master II Index
Treasury Inflation Protected Securities	Barclays US TIPS Index
Short-Term Fixed Income	91-Day Treasury Bills
Total Fund Benchmark	Target asset mix percentages are applied to individual asset class benchmarks to arrive at the total fund benchmark. The private equity allocation is scaled in over time