



Capital Markets in Distress: Past, Present, Prologue

LAFPP Board Retreat

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Where Do We Go From Here?

A Spectrum of Returns

Where Were You Invested in These Periods?

Asset Class	5-Years Returns (Cumulative)				15-Year Characteristics*	
	2008	2003-2007	1998-2002	1993-1997	Standard Deviation	Correlation with 60-40
Emerging Markets	-53	391	-21	44	26	0.54
MSCI EAFE	-43	171	-12	74	16	0.75
REITS	-39	131	23	118	15	0.34
S&P 500 Equal-Weighted	-40	109	12	136	16	0.89
Commodities	-36	95	21	58	12	-0.21
S&P 500	-37	83	-3	152	15	0.98
Emerging Market Bonds	-11	82	44	---	12	0.58
High-Yield Bonds	-26	67	3	75	7	0.66
Convertible Bonds	-36	66	20	92	13	0.85
Unhedged Foreign Bonds	10	44	28	45	9	-0.01
TIPS	-2	36	51	---	5	-0.43
Long-Term Gov't Bonds	23	32	52	62	9	-0.04
Mortgage Bonds	8	25	43	42	3	0.04
Lehman Aggregate Bond	5	24	44	43	4	0.01
Money Markets	2	16	23	26	1	0.14

Red = worst three (excl. SPEW)

Blue = best three (excl. SPEW)

The 2002 bear market was only difficult for those who were wedded to an equity-centric "normal portfolio"

The 2008 bear market has been a Take No Prisoners market

*Emerging markets and TIPS standard deviations and correlations are for the ten years ended 12-07.

Past performance is no guarantee of future results. 60-40 represents a composite of the S&P 500 (60%) and Lehman Brothers Government/Credit Bond Index (40%). Standard deviation is an absolute measure of volatility measuring dispersion about an average which, for an index, depicts how widely the returns varied over a certain period of time. The greater the degree of dispersion, the greater the risk. Correlation w/60-40 measures the correlation, or tendency to move in tandem, of the performance of the listed asset class with the 60/40 portfolio for the 15-year period ended 12/31/07. A higher number indicates a greater correlation. Emerging Markets Stocks represented by MSCI Emerging Markets Index. Commodities represented by Dow Jones AIG Commodity Index. REITS represented by Wilshire REIT Index. Emerging Markets Bonds represented by JP Morgan Emerging Markets Bond Index Global. TIPS represented by Lehman U.S. TIPS Index. High Yield Bonds represented by Merrill Lynch High Yield Master II Index. Long Term Govt Bonds represented by Lehman Brothers Long-Term Treasury Index. Mortgage Bonds represented by Lehman Brothers Mortgage. Convertible Bonds represented by Merrill Lynch ALL US Convertible Securities Index. Unhedged Foreign Bonds represented by Citigroup World ex-U.S. Government Bond Index. Money Markets represented by Citigroup 3-Month T-Bill Index. Intl Stocks represented by MSCI EAFE Index. S&P 500 Equal Weighted (SPEW) reflects the performance of the S&P 500 Index with component stocks equally weighted rather than capitalization weighted. The Standard & Poor's 500 Stock Index (S&P 500) is an unmanaged, capitalization-weighted index of U.S. companies generally representative of the U.S. Stock Market. The Lehman Aggregate Bond Index is generally considered to be representative of the domestic, investment-grade, fixed-rate, taxable bond market. Returns are not indicative of the past or future performance of any investment product.

Three Paths to Improved Return Potential

Consider Other Asset Classes

- Stocks and bonds are not the only choices
- Unconventional assets can be priced to offer better returns

Seek Alpha

- Conservatively, focusing on avoiding negative alpha, or
- Aggressively, if you have confidence in the opportunities

Actively Manage the Asset Mix

- *Include* alternative markets in these decisions
- Seek assets which are out of favor, priced for better returns

All Three Paths Can Be Pursued in Parallel!

Alpha measures a portfolio's risk-adjusted performance, which is the difference between a portfolio's actual and expected returns, given the level of market risk as measured by beta.

Alpha Stacking

Adding Value in Every Step of the Investment Decision Process

Mandate: Absolute Return with Limited Downside

Policy portfolio: Money Market

Return = 1% real, Vol = 0%



Classic Balanced Strategic Portfolio: 60/40 Stock/Bond Portfolio

Incr. Return = + 4% Incr. Vol = +9%



Advanced Strategic Portfolio: Multi-Asset Diversified

Incr. Return = + 2% Incr. Vol = -1%



Beta Selection/Implementation: Non-traditional Index Exposure

Incr. Return = + 1% Incr. Vol = +0%



Alpha Program: Low correlation overlay strategies

Incr. Return = + 2% Incr. Vol = +1%

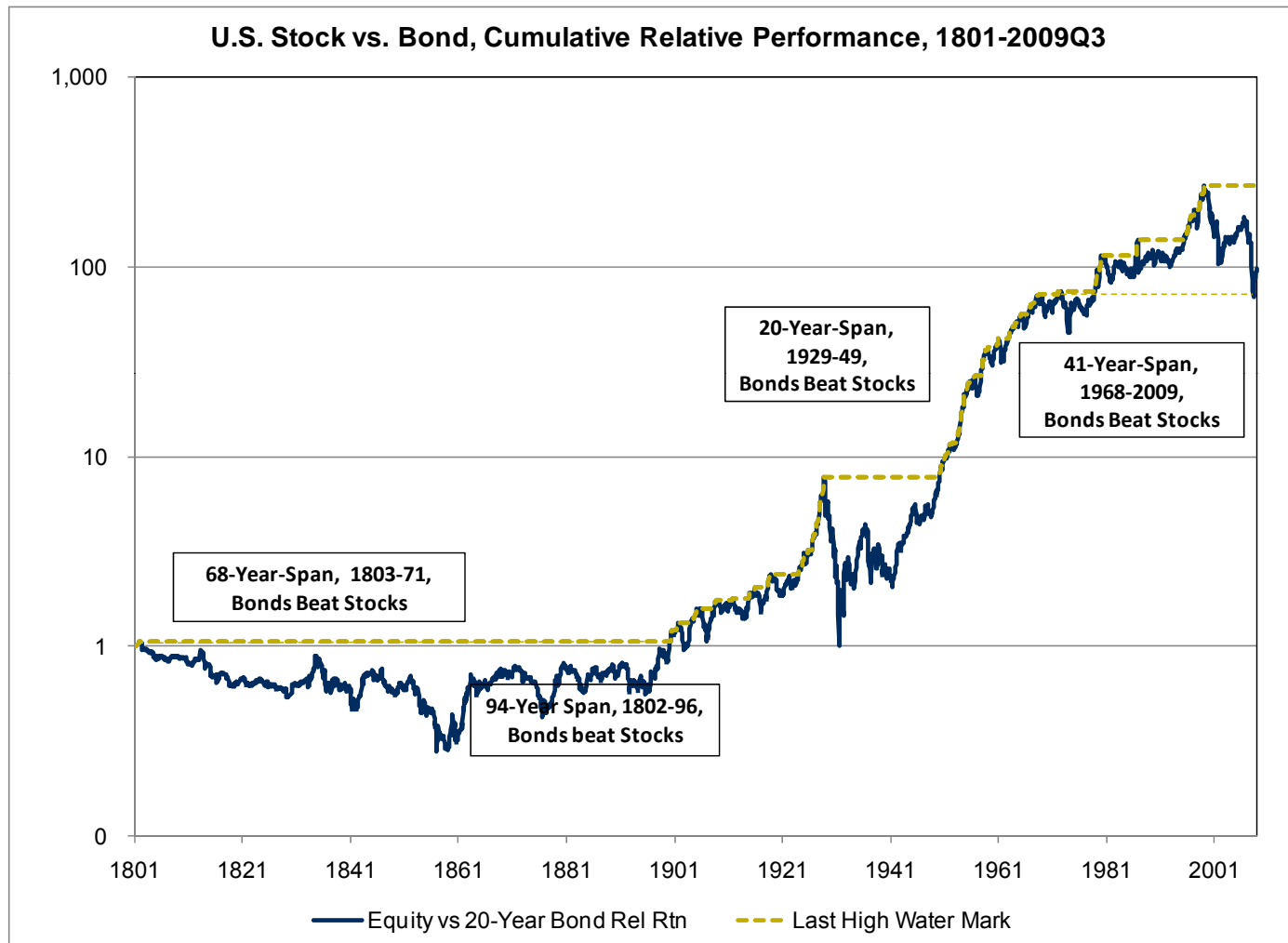


Total Absolute Program

Portfolio Return = + 10% real, Vol = 9%

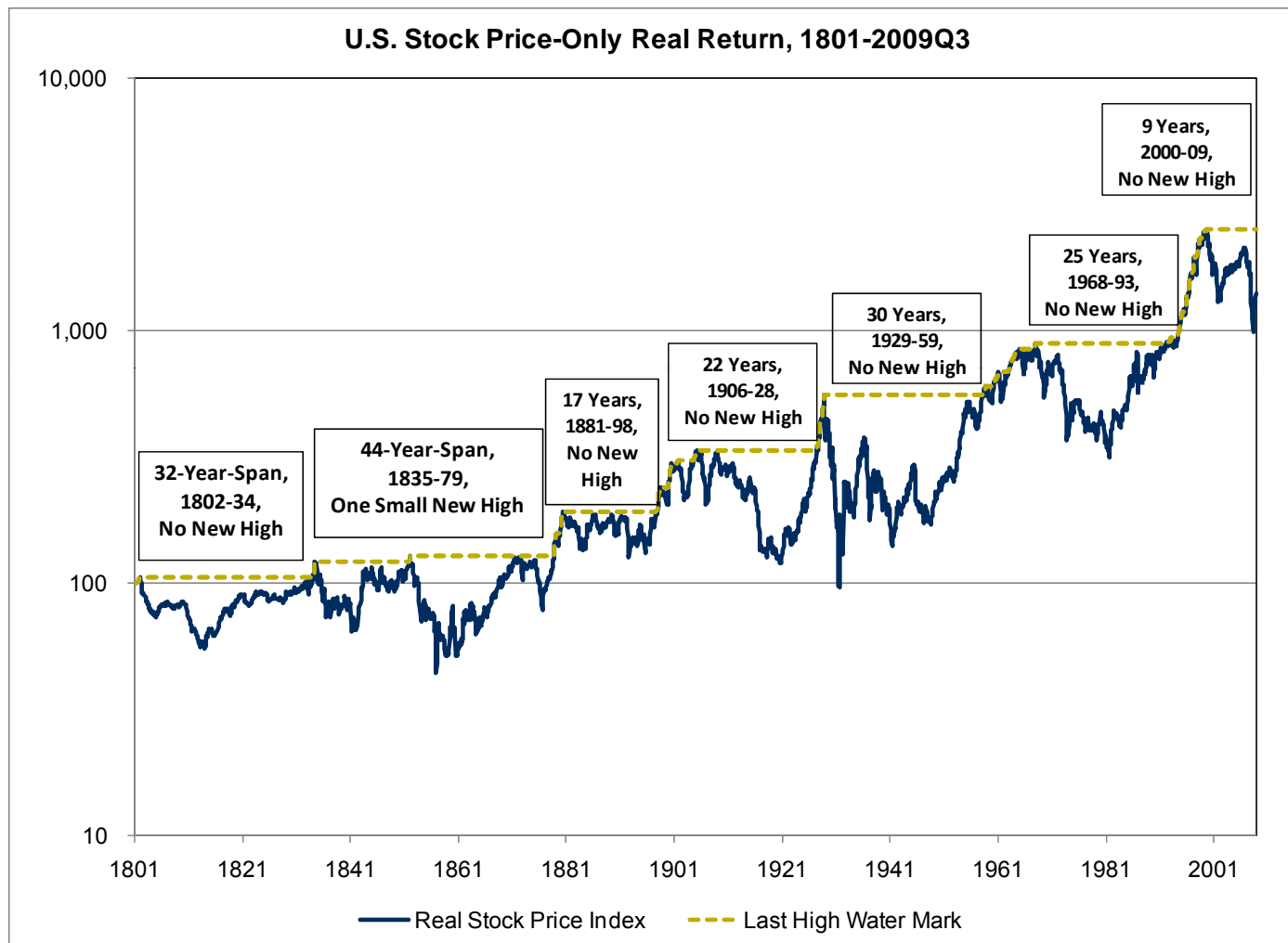
Stocks for the long run?

Stocks for the Long Run? How Long, Exactly, Do We Mean?



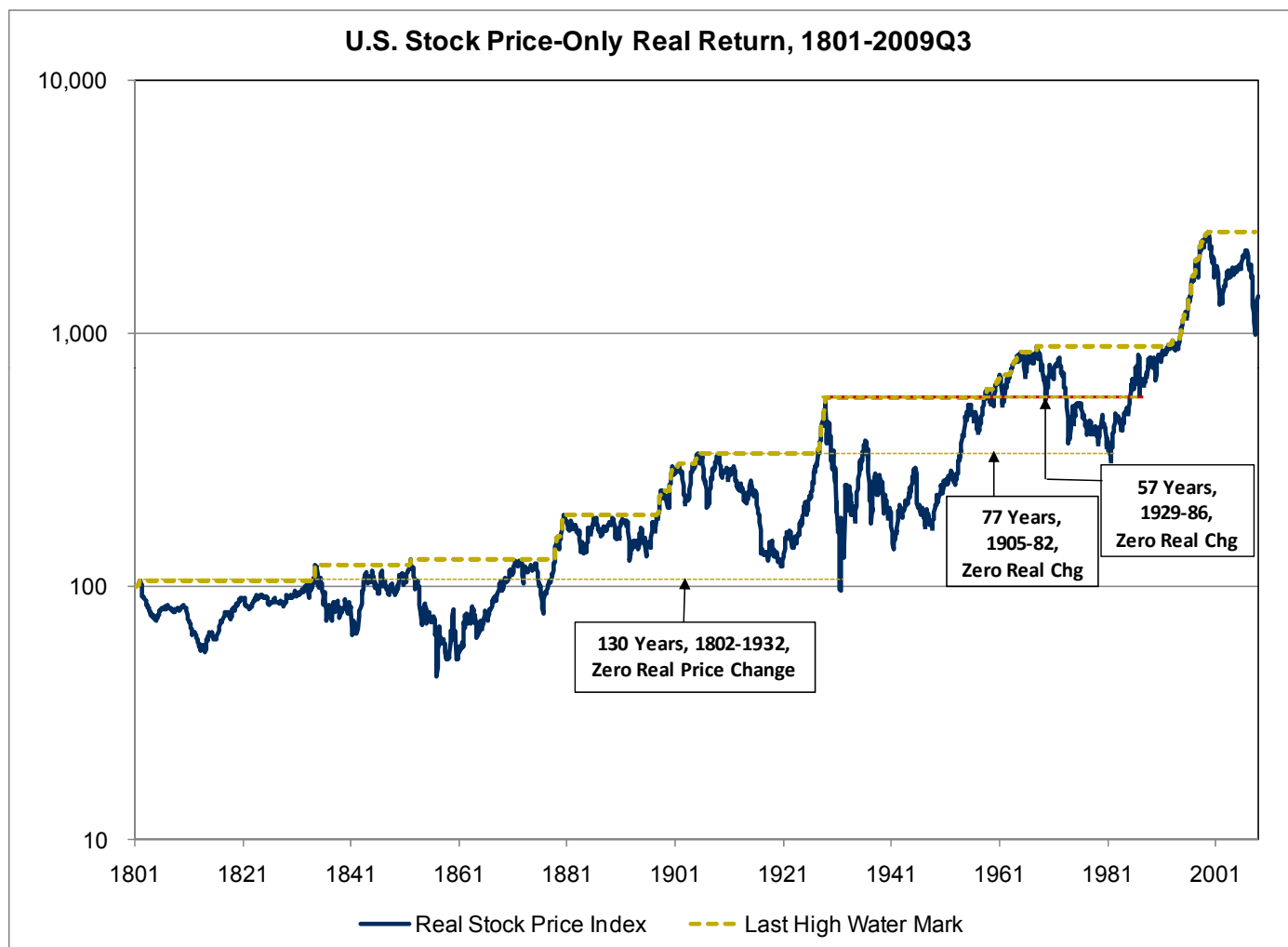
Source: Research Affiliates, LLC. Data provided by Bloomberg and Ibbotson. Equity data is an equally weighted composite of Schwert Equity Index (1800-1925), Ibbotson Equity Return (1926-2009) and FQ Equity Return (1871-1925). Bond data is an equally weighted composite of U.S. 10yr Bond Yield (1800-2009), 10Yr Yield-Global Financial Data (1871-2001), Ibbotson Bond Yield (1926-2004) and FQ Bond Yield (1959-2004).

Over Past 207 Years, Droughts Over 10 Years Span 173 Years ... Over 80% of Two Centuries



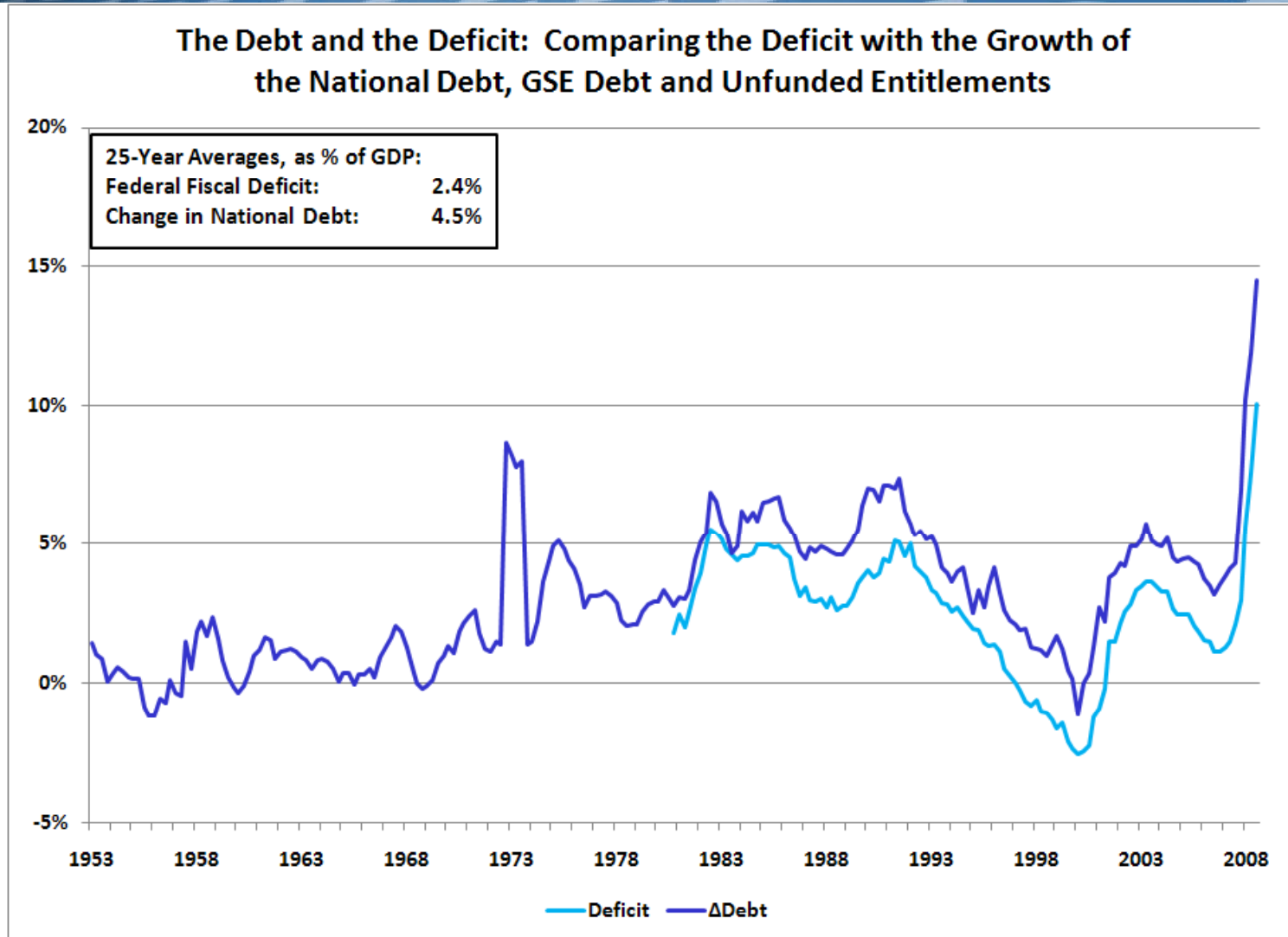
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And Old Peaks May Be Tested for Decades More



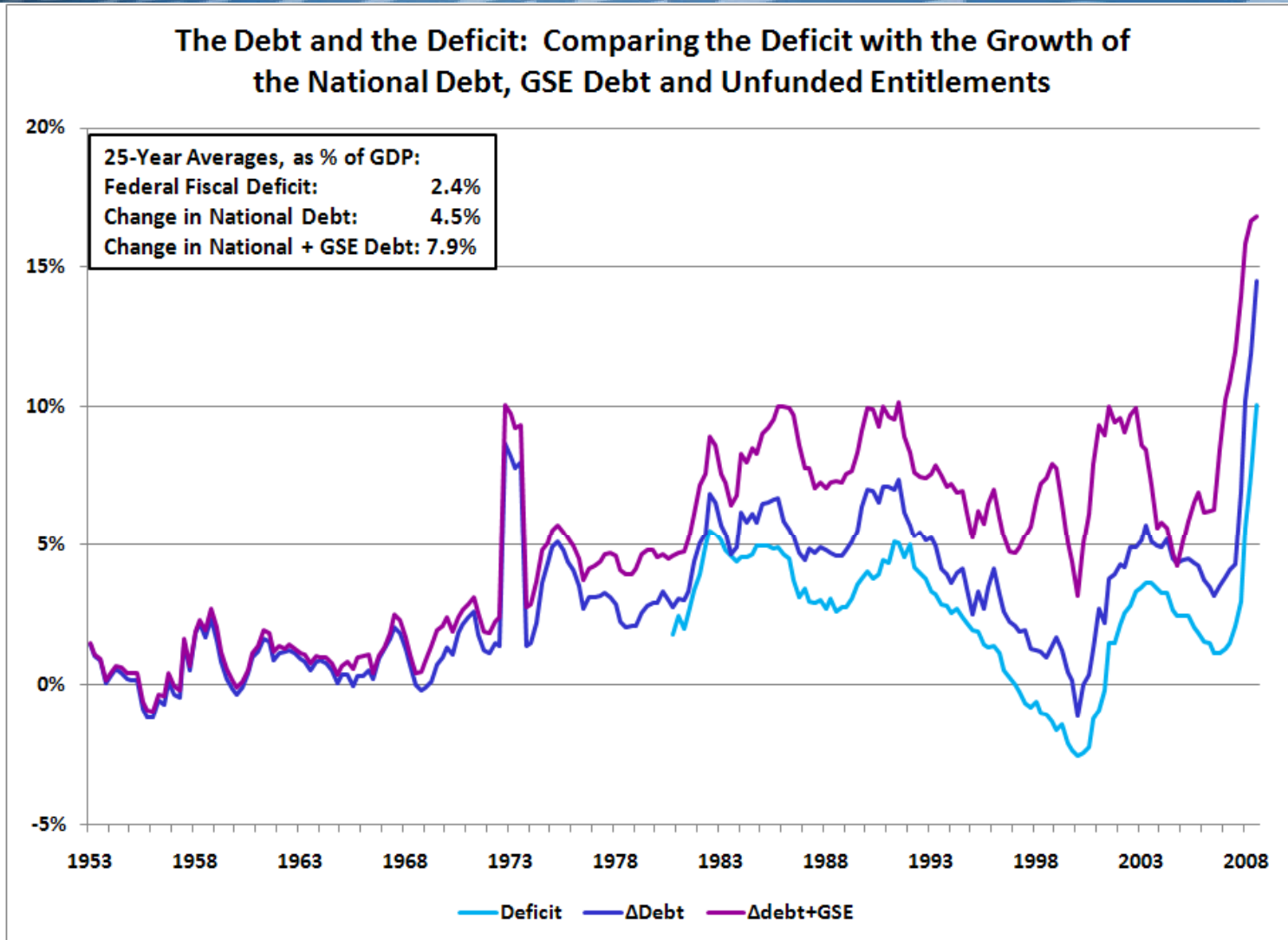
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Off-Balance-Sheet Government Expenses Swamp the Official Fiscal Surplus/Deficit Calculation



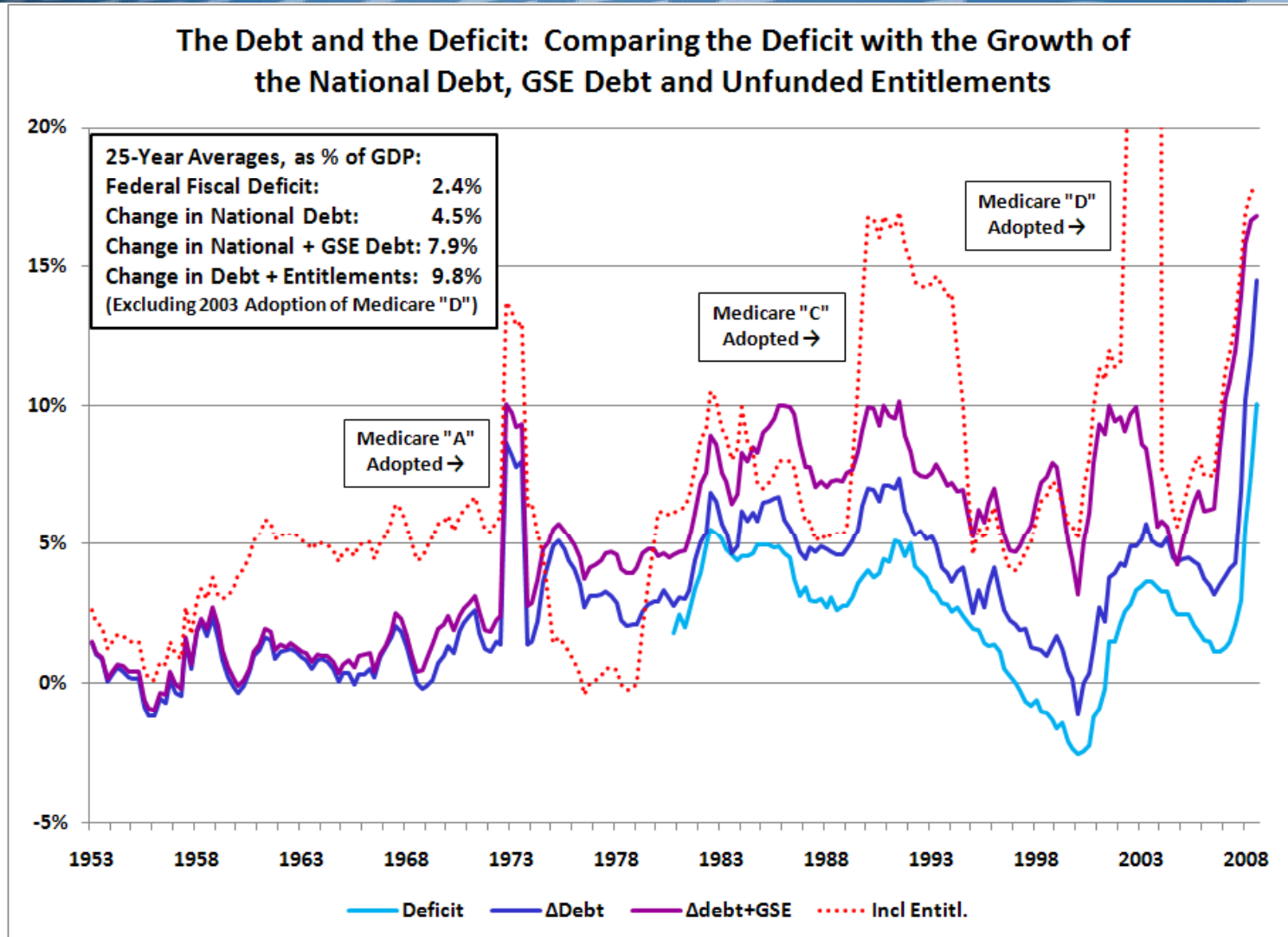
Source: Research Affiliates, LLC, based on data and projections from the US Treasury Department

GSEs, Now Fully Backed by the Government, Make the Picture Much Worse



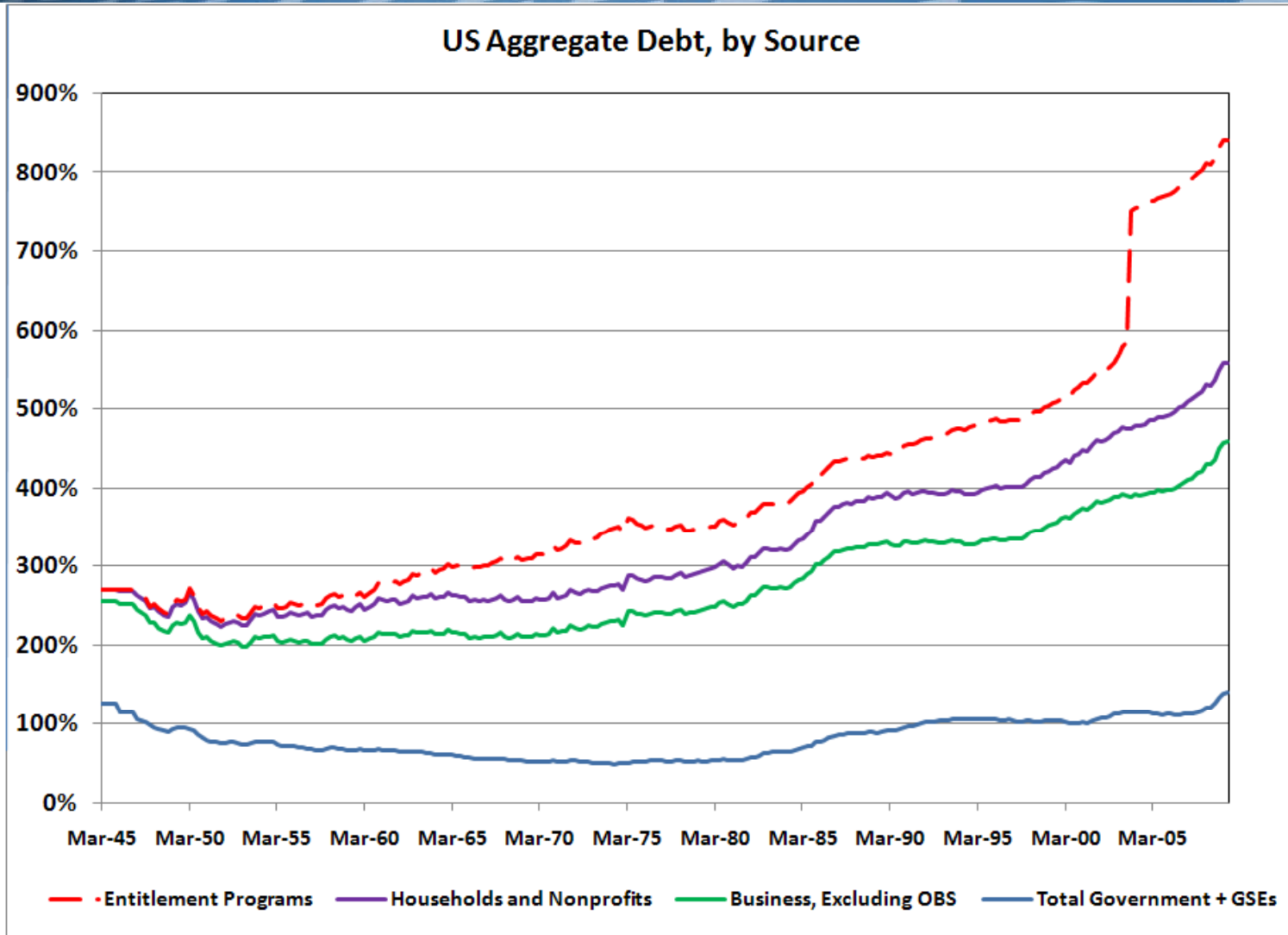
Source: Research Affiliates, LLC, based on data and projections from the US Treasury Department.

And, if We Include Unfunded Entitlements, the “Effective Deficit” Averages 10% of GDP Per Year



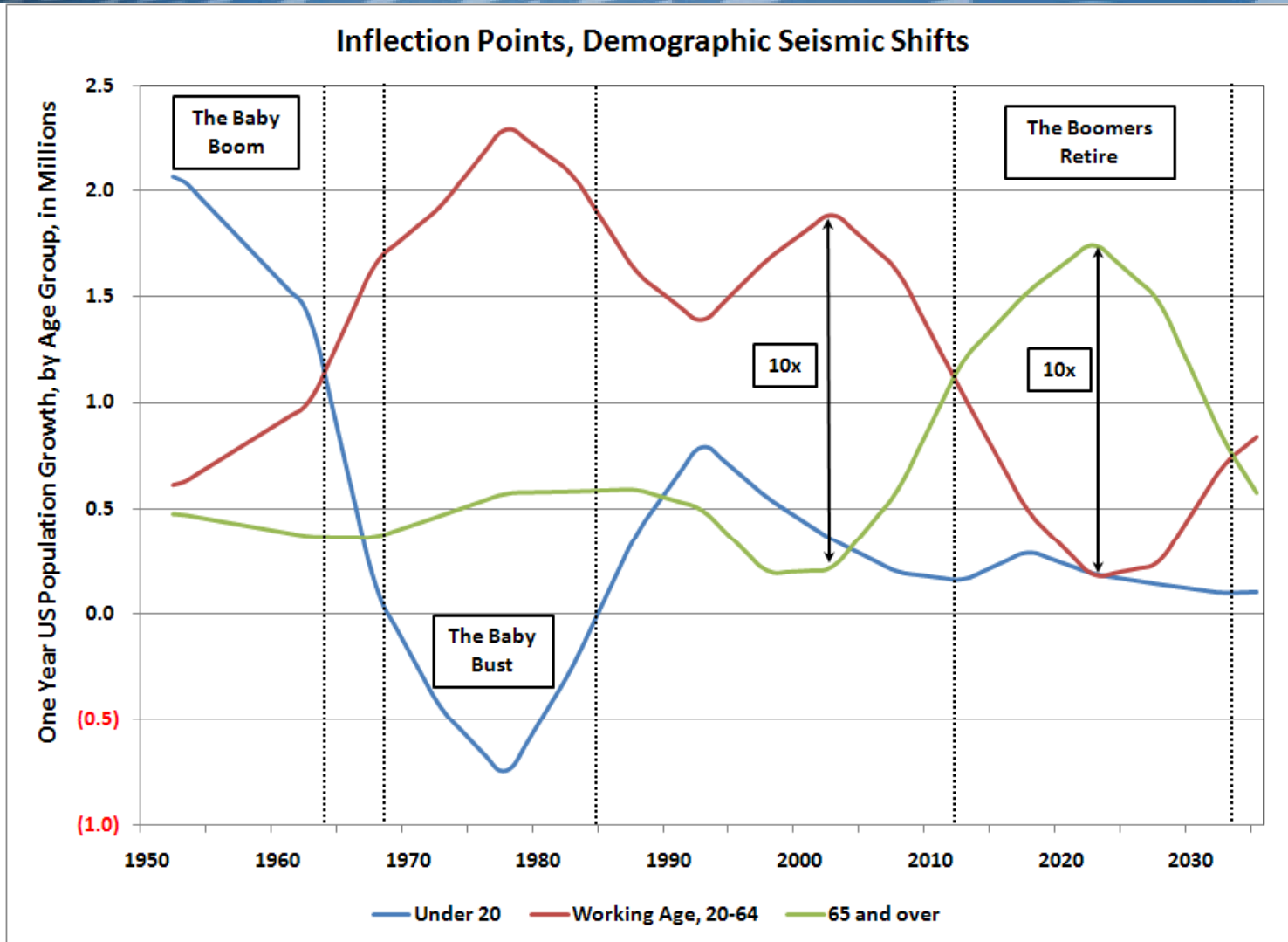
Source: Research Affiliates, LLC, based on data and projections from the US Treasury Department.

Public Debt, Total Debt and Entitlement Obligations are Growing at a Frightful Pace



Source: Research Affiliates, LLC, based on data from the US Federal Reserve Flow of Funds database and the US Social Security Administration.

And Demographics Won't Make This Any Easier in the Years Ahead

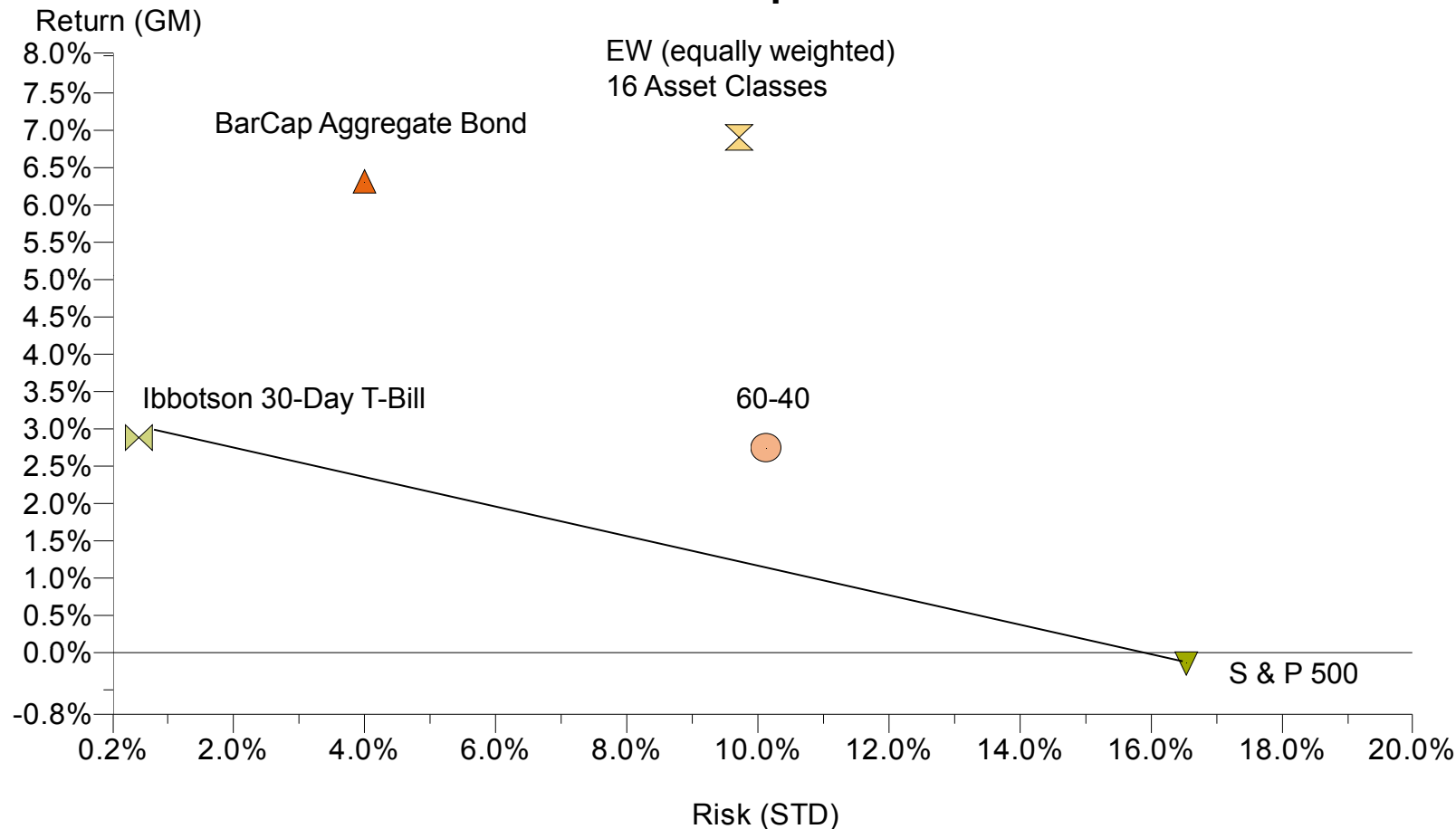


Source: Research Affiliates, LLC, based on population data and projections from the US Social Security Administration.

A Capital Market Line Inversion

(Why, Exactly, Do We Seek Equity-Like Returns at Bond-Like Risk?)

Risk vs. Return October 1999 - September 2009



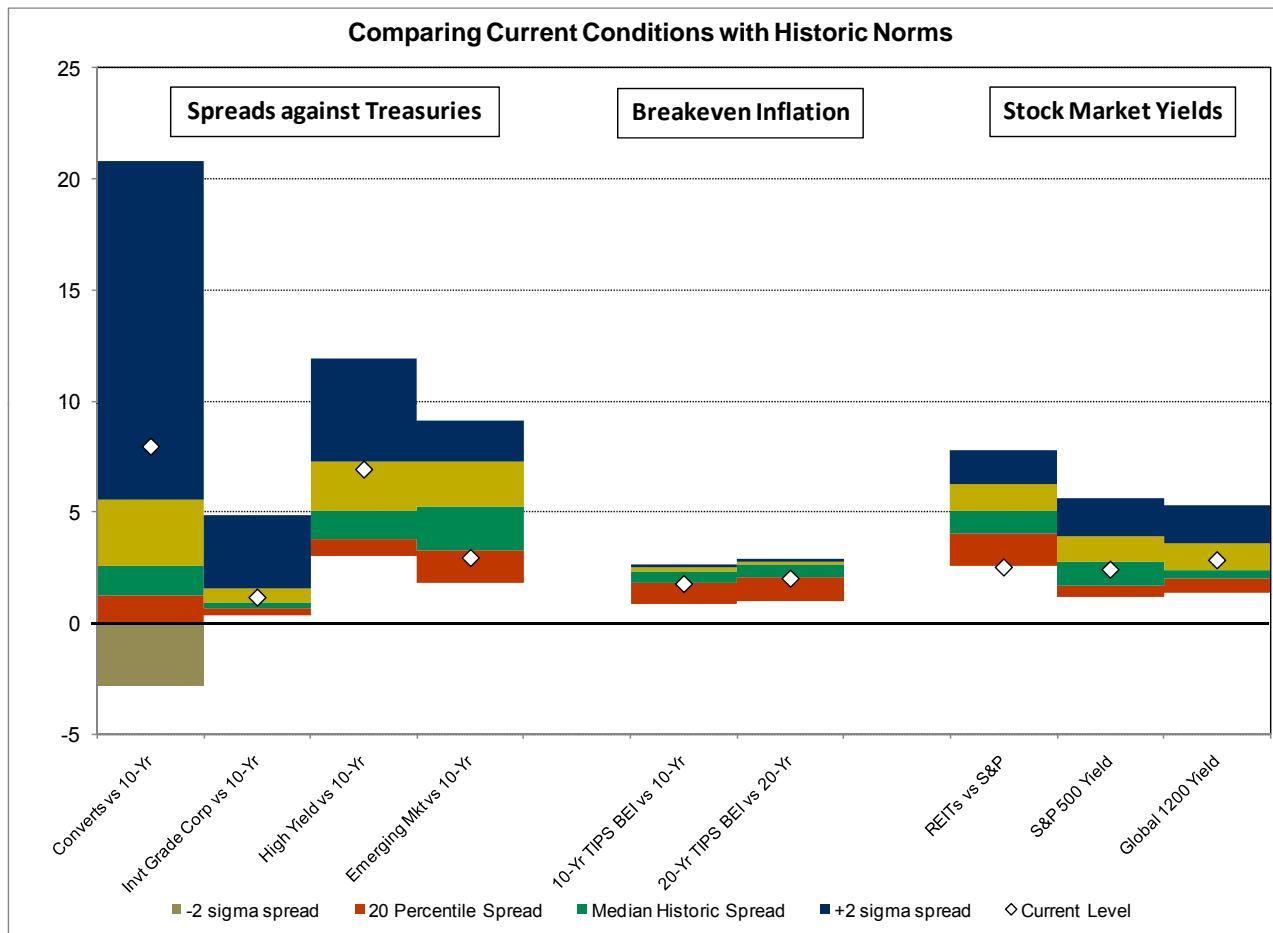
The Equally –weighted portfolio is comprised of the following indexes, rebalanced monthly. ML US Corporate & Government 1-3 Year; BarCap US Aggregate Bond TR; BarCap US Treasury Long TR; BarCap US Long Credit TR; BarCap US Corporate High Yield TR; Credit Suisse Leveraged Loan; JPM EMBI + Composite TR; JPM ELMI + Composite; ML Convertible Bonds All Qualities; BarCap Global Inflation Linked US TIPS TR; FTSE NAREIT All REITs TR; DJ AIG Commodity TR; S&P 500 TR; MSCI Emerging Markets TR; MSCI EAFE TR; Russell 2000 TR. The 60-40 portfolio is 60% S & P 500 TR and 40% BarCap Aggregate Bond TR rebalanced monthly. Past performance is no guarantee of future results. Source: Lehman, Merrill, JPMorgan, Russell, Credit Suisse, S&P, MSCI, Dow Jones, Bloomberg, Ibbotson



Where Are the Opportunities Today?

Yields and Spreads, September 30, 2009

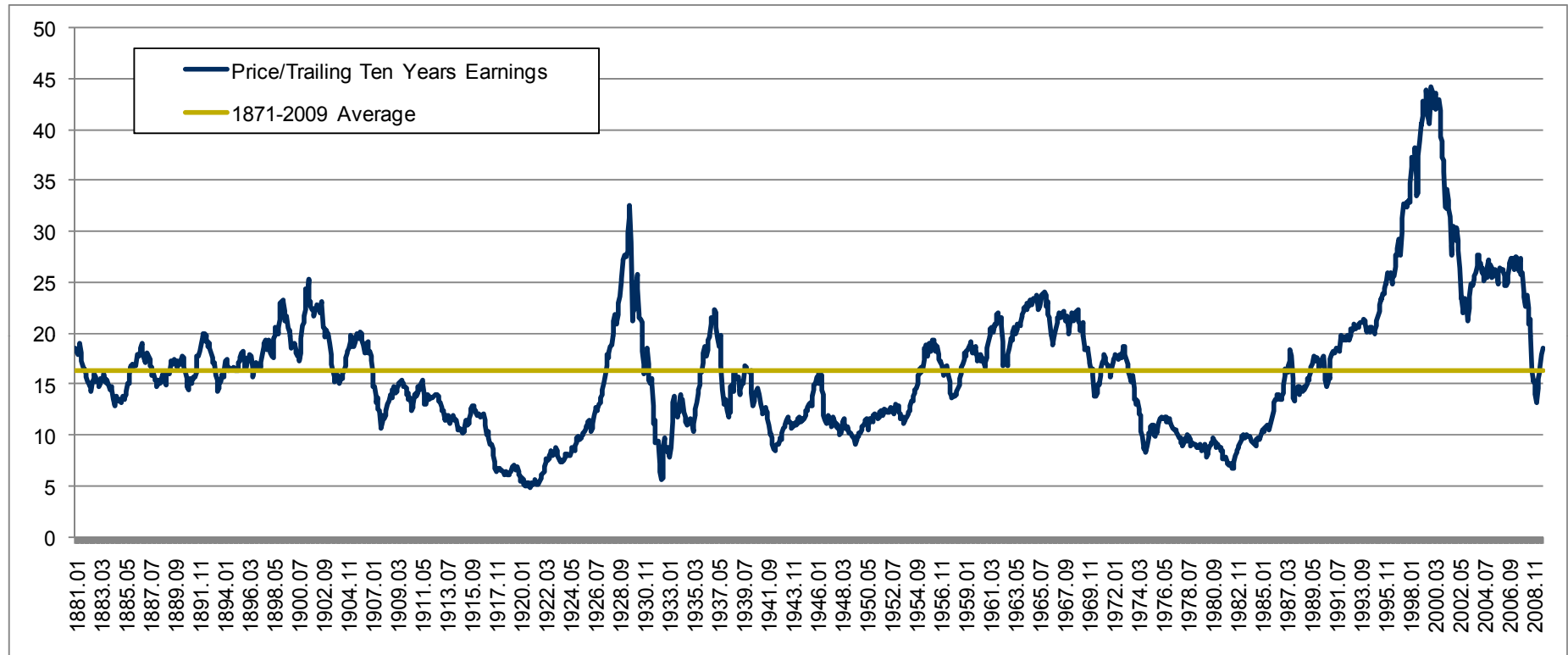
Opportunity Diminishing



Indexes used (with start dates) were Barclays Capital US Convertibles (Converts – 1/31/2003), Barclays Capital US Intermediate Corporate (Inv Grade Corp – 1/31/90), Merrill Lynch High Yield Master II (High Yield – 9/30/86), Merrill Lynch USD Emerging Market Sovereign Plus (Emerging Mkt – 12/31/91), NAREIT Total (REITs – 1/31/80), S&P 500 (1/31/80) and S&P Global 1200 (Global 1200 – 7/31/04). 10-Year Treasury (1/31/80), 10-Year TIPS (1/31/03) and 20 year TIPS (1/31/03) all taken from the Federal Reserve Constant Maturity series. The boxes are from 2.5th to 20th percentile, 20th to 50th percentile, 50th to 80th percentile, and 80th to 97.5th percentile of historical observations. Spread versus Treasuries is calculated as Option adjusted Spread for Convertibles and yield to worst for Inv Grade Corp, High Yield, and Emerging Mkt.

Sources: Research Affiliates, LLC, Bloomberg, Merrill Lynch, Lehman Brothers. Study from Morningstar and Ibbotson

U.S. Equities Priced at “Above Average” Valuations

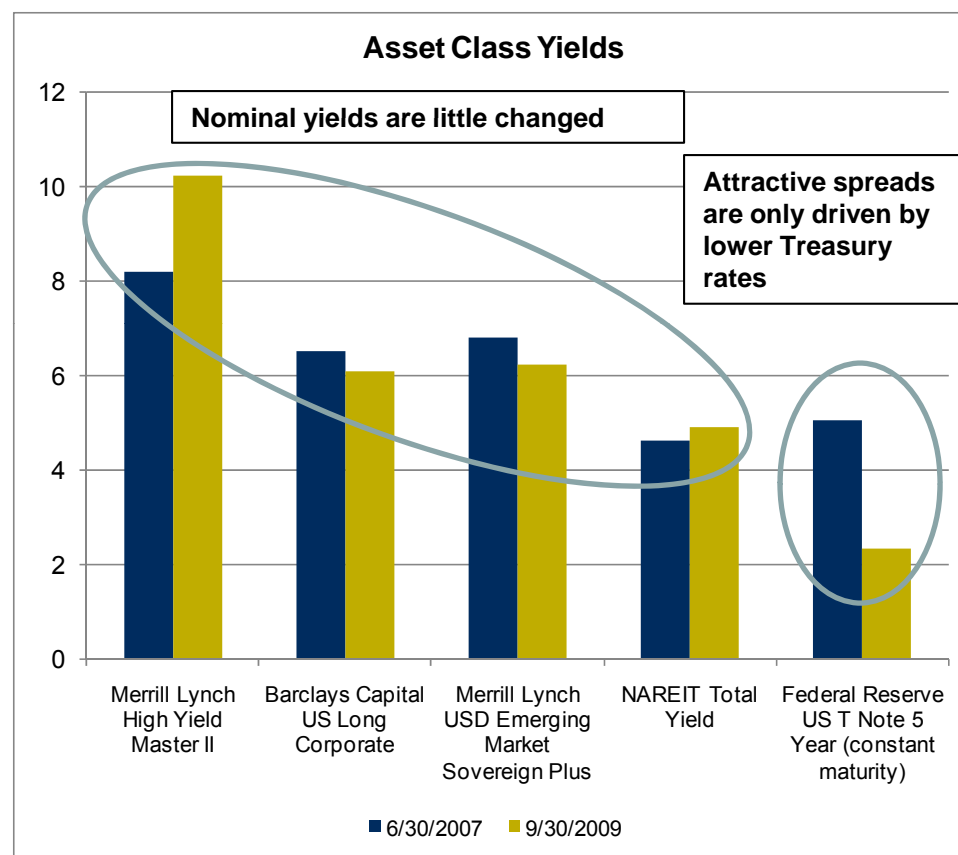


Above average valuations in the face of tremendous uncertainty—re-regulation, deleveraging, protectionism, and deglobalization—isn’t compelling from a risk and reward standpoint.

Source: Research Affiliates, LLC based upon data from Robert Shiller.

Nominal Yields—What Global Recession?

- **Nominal yields for many credit asset classes are at pre-crisis levels after 2009 rally**
- **After subtracting today's lower Treasury yields, "spreads" look attractive but is the real return investor really better off?**
 - 0–25 bps Fed Funds
 - Quantitative easing
- **Mild stagflation makes these assets less attractive today than before Credit Crisis!**



Refer to Appendix for additional index information.

Source: Research Affiliates, LLC. Data is from Bloomberg.

Tech Bubble vs. Financials Anti-Bubble

TMT bubble set the stage for seven years of value outperformance!

- Russell 1000 Value annualized return 1/1/2001–12/31/2007: 6.74%
- Russell 1000 Growth annualized returns 1/1/2001–12/31/2007: 0.23%
- FTSE RAFI US 1000 annualized return 1/1/2001–12/31/2007: 7.73%

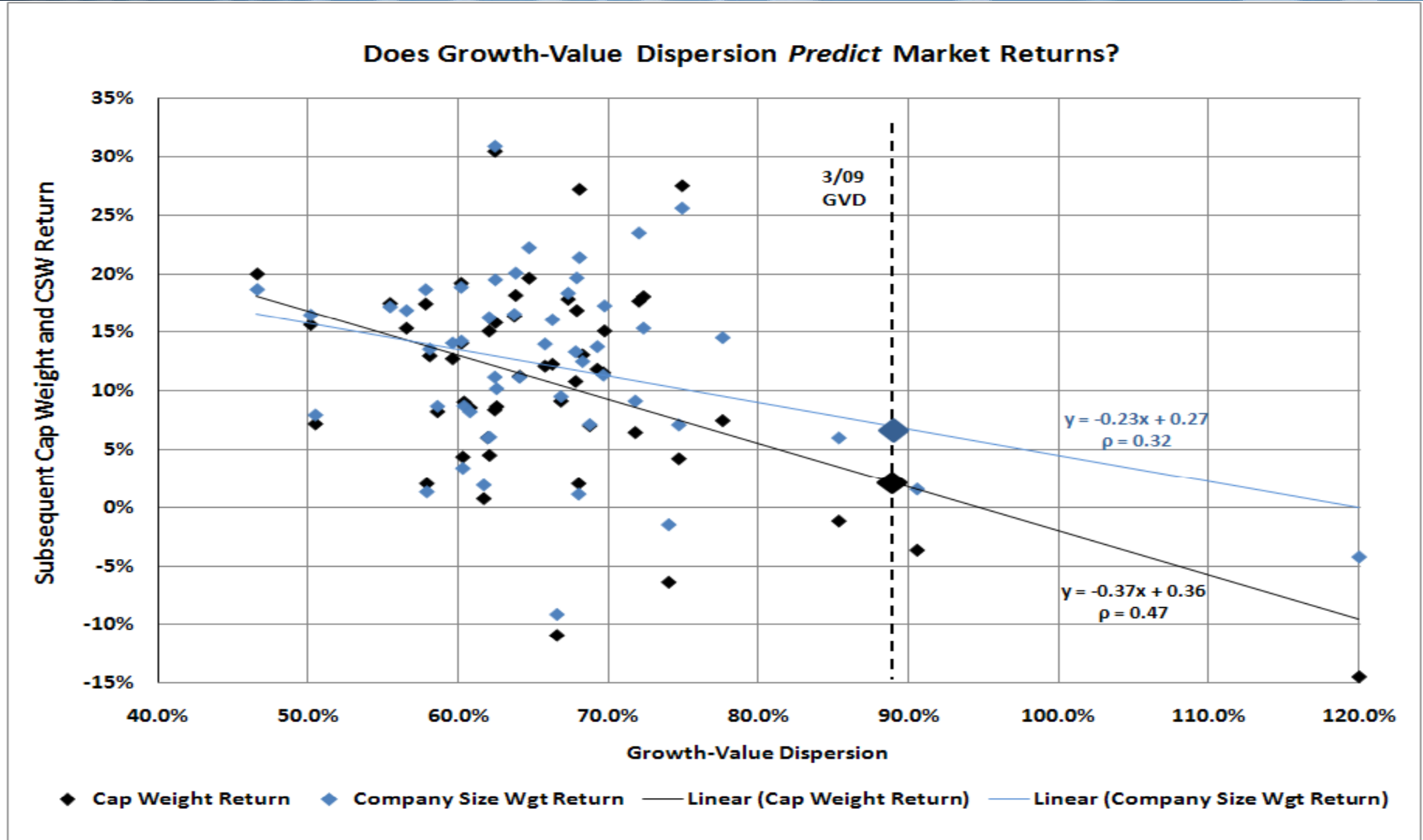
Anti-Bubble

- Value discount relative to growth is near the largest in history, exceeded only during the TMT bubble in 1999–2000

	9/30/2009			3/31/2000		
	Price/Sales	Price/Book	Positive Price/Earnings	Price/Sales	Price/Book	Positive Price/Earnings
Russell 1000 Value	0.92	1.53	12.89	1.32	2.69	16.98
Russell 1000 Growth	1.46	3.57	16.55	4.17	9.21	45.23
Discount	-37%	-57%	-22%	-68%	-71%	-62%
MSCI EAFE Value	0.72	1.24	13.62	0.98	2.01	22.18
MSCI EAFE Growth	1.05	2.22	17.26	2.38	5.57	35.62
Discount	-31%	-44%	-21%	-59%	-64%	-38%

Source: Research Affiliates, LLC., based on data from Bloomberg.

The Dispersion of Valuation Multiples May Predict Market Returns



Source: Research Affiliates, LLC.

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