



September 18, 2008

An Open Letter to the SBCERA Membership:

As you may have surmised from the recent press reports, it is a very difficult investment environment. With the turmoil this past year culminating in the recent headline-grabbing failures, I wanted to take this opportunity to provide you with a brief synopsis of the markets and the impact of the recent market failures on the San Bernardino County Employees' Retirement Association fund. In addition, I will briefly describe how we have defensively re-positioned the fund over the last few years to reduce overall risk, while taking advantage of opportunities in the markets.

The tipping point of the recent market turmoil can be traced back to early 2007 when Bear Stearns' troubles became public ending in a forced liquidation to JP Morgan. It soon became apparent that over-levered balance sheets were not isolated issues, but a systemic problem. The over-levered balance sheets of two entities— the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Association (Freddie Mac) whose very existence is to provide liquidity to the market— fell prey to the mortgage meltdown requiring a substantial capital infusion by the U.S. Government.

On a global basis, investors hoped that bailout of Freddie and Fannie would be a backstop to the downward spiral, albeit to no avail. Lehman has since filed for bankruptcy; Merrill Lynch, too weak to stand alone, sold itself to Bank of America; and AIG avoided immediate bankruptcy through another cash infusion by the U.S. Government. The markets continue to sell off with the Dow Jones Industrial Average plummeting 504.48 points on Tuesday, September 16th, making it the worst one-day decline since September 17th, 2001, which was the first trading day after the terrorists' attacks in the U.S.

I am pleased to report that the impact of the aforementioned failures on the SBCERA portfolio is negligible from a performance standpoint. We had no exposure to Bear Stearns. We had no active direct exposure, debt or equity, to Fannie Mae or Freddie Mac. The only exposure to these securities would be in relation to their relative equity weighting within the S&P 500 or other broad market indices to which the fund has index-based exposure. With regard to the S&P 500 Index, they represented only approximately 0.015% of the index on September 9, 2008, one day prior to being dropped from that index.

In regard to Lehman Brothers, the fund had direct exposure to slightly less than one million dollars of the preferred equity securities and approximately two million dollars of debt security exposure. In addition, we have exposure to a \$10 million face value principal-protected note that we are currently reviewing with outside counsel. Our internal estimates of the total worst case loss related to Lehman from all of these positions should be limited to

approximately \$8 million or only 0.13% of the fund's \$6 billion value. While no investor takes losses easily, this is a remarkable outcome in these unprecedented times.

From a strategy standpoint, the Board made substantial asset allocation shifts earlier this year, resulting in a more defensive position. The primary drivers were a substantial reduction in public equity, or stocks, from 47% to 35% and an increase in credit strategies to take advantage of the dislocation in the bond markets, inclusive of both corporate debt and asset-backed bonds. Over the last few years, we have been building positions in distressed debt, real estate debt and private debt strategies in anticipation of a downturn.

Over time, the Board and staff have implemented a successful investment program that consistently ranks as top-performer in both absolute and risk-adjusted performance. On a three and five-year basis ending June 30, 2008, SBCERA's performance ranked it in the top 5% and 8%, respectively. On a risk-adjusted basis, SBCERA ranked in the top 5% of all public funds¹ on both a trailing three and five-year basis. While no strategy works immediately, the fund is well positioned to take advantage of current market dislocations and will perform very well over the next 24 months.

These are serious and unprecedented times in the financial markets; however, your pension plan remains the *Foundation for a Secure Retirement* through continued planned strategy and professional management by your Board of Retirement.

Sincerely,

Timothy B. Barrett, CFA
Executive Director/Chief Investment Officer

¹ All "public funds" is based on the Independent Consultants Cooperative (ICC) performance universe. The ICC is a unique alliance of 18 independent consulting investment firms and State Street Bank. It is the largest in the industry, representing 21, 562 client portfolios and 1,392 Total Funds (investment programs).