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TO: Governor Dave Freudenthal
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FROM: State Treasurer Joe Meyer

DATE: March 17, 2009

SUBJ: ASSET ALLOCATION REVIEW

The State Treasurer's Office and RV Kuhns review each spring the asset allocation targets for the funds within the state investment portfolio: the Permanent Wyoming Mineral Trust Fund, Common School Permanent Land Fund, University Permanent Land Funds, the remaining Permanent Land Funds, the Hathaway Scholarship Endowment Fund, Higher Education Endowment Fund, Workers Compensation Fund, Tobacco Settlement Fund and the State Agency Pool.

You will recall that last fall the State Treasurer's Office asked RV Kuhns to revisit their long-term risk and return assumptions given deteriorating market conditions. In November, we sent to the State Loan and Investment Board an "Interim Asset Allocation Target" study that has served as our guide for allocating new money coming into the state's portfolio through February.

The attached "Asset Allocation Discussion" from RV Kuhns contains new long-term asset allocation targets for the funds within the state's portfolio based on their now completed risk and return study. The State Treasurer approves of some recommendations because of their obvious benefits. They are outlined first below.

The Treasurer recommends further discussion among Board members of RV Kuhns's recommendations regarding the US and international equity portfolios, as explained later in this memo.

RV Kuhns outlines the results of their study in the attached Executive Summary to the report. We have also included two additional information pieces:
• A snapshot of the portfolio showing unrealized gains or losses and realized income or loss by manager for June 30, 2008 and January 31, 2009.
• A five-year look at manager income gross and net of fees.

RV Kuhns will discuss the attached report and their recommendations at the April 9, 2009 meeting of the State Loan and Investment Board (SLIB.) At that time, the Board may adopt all or part of this plan and the necessary amendments to the Master Investment Policy.

NEW LONG-TERM ASSET ALLOCATION PLAN

Fixed Income

The revised asset allocation increases portfolio fixed income from 43 percent to 45 percent. The 2 percent increase will be spread pro-rata across all of our fixed income managers, including the internal portfolio.

Absolute Return

The new plan increases our allocation to hedge funds from 5 percent to 7.5 percent in the applicable funds through our current relationships with Harris Alternatives and PAAMCO. With Harris, we will place future funds into their new Aurora II Fund at a reduced fee of 75 basis points compared to the current 100 bps. Aurora II will look very much like Aurora I, our current investment. For example, 90 percent of the managers will overlap.

Real Estate

We will increase our allocation to real estate from 5 percent to 7.5 percent. “Core” real estate will be 4 percent and remain split between our current managers ING and UBS. “Value-added” will be 3.5 percent. Heitman and TA Realty are our current value-added managers. The real estate team at RV Kuhns will vet future value-added real estate opportunities. The team will bring appropriate investments to the Treasurer’s Office. If the Treasurer’s Office approves of the investment, the Treasurer will bring the investment to the SLIB for discussion. The SLIB approves all alternative investment contracts.

First Quadrant

Wyoming's current overlay strategy "overlays" the State's large cap S&P 500 Index portfolio using options to add uncorrelated extra return and to decrease risk. Options are contracts giving someone the right, but not the obligation, to buy or sell stocks at a set price up to a certain date. First Quadrant buys and sells option contracts that they believe provide a premium for the amount of risk imbedded in the contract. First Quadrant currently has the authority to buy options on $500 million of the market value of our S&P Index fund. We will increase that to the full amount of our S&P Index fund – about $800 million and adjust it each year to what the value is at that time. We would also allow the program to overlay any Large Cap Enhanced Index fund, if we add that to the portfolio as recommended below by RV Kuhns.

US AND INTERNATIONAL EQUITIES

Large Cap US Equity

The new asset allocation plan reduces large cap exposure from 16 percent to 15 percent in the permanent funds. It also recommends transitioning 25 percent of our large cap exposure to an Enhanced Index product.

Small/Mid Cap US Equity

The new plan reduces the allocation to small/mid cap equity from the current 8 percent target to 3 percent in the permanent funds. The Treasurer's Office would meet this target over time by not allocating any new funds to this strategy until the allocation is at the 3 percent target.

The State Treasurer cautions, however, there are several issues to consider.

• We have two managers in the Small/Mid Cap space: Friess Associates and GAMCO. They are active managers with different strategies. Their combined fees are approximately $4 million per year. Their current investments are $470 million on a cost basis, with a market value of $390 million.

• Friess has high portfolio turnover and the firm took actual capital losses in excess of $76 million through January 2009. Their portfolio still retains an unrealized loss of approximately $7 million.

• Gabelli, with low portfolio turnover, has realized no net capital losses; but the portfolio contains just under $73 million in unrealized losses.

• The current practice of the State Treasurer's Office is to monthly recognize capital losses, reduce monthly income from all sources accordingly and thereby restore losses each month to the corpus of investment funds. Thus income from investments for FY 09 has been decreased by $76 million.

RV Kuhns recommends:

• Decreasing exposure to Small/Mid Cap equity investments

• Retaining both Friess and GAMCO.

Initial recommendations from State Treasurer, subject to further review of RVK recommendations, are:

• Consider terminating Friess Associates and replacing with a Small/Mid Cap Index Fund. The Friess style of investments can result in significant capital losses in certain environments, such as have existed over the past six months. The number one investment policy of SLIB is preservation of capital. In order for Friess to meet that preservation policy, can Friess earn back the $76 million in the future in addition to normal beta earnings?

International Equity

The new plan reduces our allocation to international equities in the permanent funds from 14 percent to 13 percent.

• We have two international managers: Capital Guardian and Fisher Investments. They are active managers with different investment strategies. Their fees total approximately $5 million per year. We have $929 million invested, worth $593 million.

• Cap Guardian, with high portfolio turnover, took total actual capital losses in excess of $60 million through January 2009. The portfolio still has $132 million in unrealized losses.

• Fisher Investments, with a low portfolio turnover style, took no net capital losses through January 2009; but the portfolio contains $204 million in unrealized capital losses

• Same discussion from Small-Mid Cap investments as to recognition of capital losses.

RV Kuhns's recommendations:

• We should replace Fisher Investments and retain Cap Guardian.

Initial recommendations from State Treasurer subject to further review of RVK recommendations:

• Consider terminating Cap Guardian and replacing with an International Index Fund.
• Same discussion on recognition of capital losses as provided under Small-Mid Cap.

INCOME VS. TOTAL RETURN

The State Treasurer does not have to recognize capital losses and restore capital losses to corpus from all income monthly. It has just been a matter of practice in the Office. Idaho permits capital losses to permanent funds to be repaid over a four-year period, which would decrease problems predicting annual investment income flows upon which budgets have been predicated. It is not even clear that there is any constitutional or statutory requirement that investment losses to corpus of permanent funds must be restored from general income or appropriation.

A possible procedure going forward would be to track capital gains and losses during the course of each fiscal year. Prior to determinations under the spending policy statutes, capital losses and gains during the course of the fiscal year would be netted and the resulting balance would be added to other income for spending policy purposes. Monthly income being distributed during the course of the fiscal year would be unaffected by whatever capital gains and losses were realized monthly.

A point of information: RVK in common with other financial advisors measures manager performance by total return, which includes all cash produced plus market value swings. Thus, there is no measurement between managers who produce more cash as an element of total return vs. managers which have the same total return but with less cash production within the total return. SLIB investment policies and statutes tend to dance around as to whether total return, long term growth, is more important for state investment policies vs. income production as a major element of total return.

Some examples from our policies and statutes are "invest for maximum safety", "preserve capital in the overall portfolio", "capital appreciation, total return, protect against inflation", have an ongoing cash flow activity, and the like. If the state treated capital gains and losses as elements to preserve capital and protect against inflation which would be placed into corpus and all other income would be fed into revenue streams, these policy objectives would be easier to meet.