

**SANTA BARBARA COUNTY**  
**EMPLOYEES' RETIREMENT SYSTEM**



**INVESTMENT GOALS,**  
**POLICIES, AND PROCEDURES**

January 2007

## TABLE OF CONTENTS

	<u>Page</u>
SECTION 1	3
Purpose	4
Policies and Procedures	6
SECTION 2	9
Plan Asset Allocation Guidelines	10
Plan Asset Allocation Characteristics	11
Performance Objectives	14
Table 1 - Five Year Performance Objectives	15
Table 2 - Objectives for Individual Portfolio Components	17
SECTION 3	18
Manager Guidelines	19
Plan Asset Allocation Managers	20
Investment Management Guidelines and Objectives	21
SECTION 4	32
Glossary of Investment Terms	33
Indices	33
Statistical Terms	34

## **SECTION 1**

## Purpose

This document will provide the framework for the investment management of the Santa Barbara County Employees' Retirement System (System). Specifically, it will address:

- ~ the general goals of the investment program
- ~ the policies and procedures for the management of the System's assets
- ~ specific investment guidelines (asset allocation)
- ~ performance objectives

The philosophy incorporated herein is to allow for sufficient flexibility in the management process to capture investment opportunities as they occur, yet set forth reasonable parameters to ensure prudence and care in the execution of the investment program.

## General Investment Goals

The general investment goals are broad in nature to encompass the purpose of the retirement program and its investments. They articulate the philosophy by which the System will manage the assets of the retirement plan within the applicable regulatory constraints.

1. The overall goal of the System's retirement program is to provide timely and sufficient benefits to its participants and their beneficiaries, as required under the plan, through a carefully planned and executed investment program.
  
2. The System seeks to produce a return on investment that is based on levels of liquidity and investment risk that are prudent and reasonable, given prevailing capital market conditions. While the System recognizes the importance of the preservation of capital, it also adheres to the theory of capital market pricing which maintains that varying degrees

of investment risk should be rewarded with compensating returns. Consequently, prudent risk-taking is justifiable.

3. The System's investment program shall at all times comply with existing and future applicable state and federal regulations including but not limited to the California Constitution as amended by Proposition 21.

## Policies and Procedures

Webster's Dictionary defines "policy" as a "plan or principle" and "procedure" as the "method" by which a task is accomplished. Together, the policies and procedures for the investment program guide its implementation and outline the specific responsibilities of the Board of Retirement ("the Board") for Santa Barbara County.

Therefore, it is the policy of the Board that:

1. The investment of the assets of the System shall be based on a financial plan that will consider:
  - ~ the financial condition of the retirement plan
  - ~ the expected long-term capital market outlook
  - ~ the Board's risk tolerance
  - ~ future growth of active and retired participants
  - ~ inflation and the rate of salary increase
  - ~ cash flow.

The financial plan measures the potential impact on pension costs of alternative investment policies in terms of risk and return based on various levels of asset diversification and the current and projected liability structure of the retirement plan.

2. Based on the financial plan, it will be the responsibility of the Board to determine the specific allocation of the investments among the various asset classes considered prudent given the retirement plan's liability structure. The long-term allocation guidelines shall be expressed in terms of ranges for each asset class to provide sufficient flexibility to take advantage of shorter-term market opportunities as they may occur. The asset allocation, which is the System's investment structure, shall be sufficiently diversified to maintain risk at a reasonable level as determined by the Board without imprudently sacrificing

return. The Board shall determine performance benchmarks against which the asset allocation plan shall be reviewed to ensure that the asset mix remains appropriate to meet the long-term goals of the retirement program. The System will review annually its current financial plan.

3. In accordance with the asset allocation guidelines the Board will select external investment managers with demonstrated experience and expertise whose investment styles collectively will implement the planned asset allocation. The Board will set guidelines for these managers and regularly review their investment performance against stated objectives.
4. It is the responsibility of the Board to administer the investments of the System at the lowest possible cost, being careful to avoid sacrificing quality. These costs include but are not limited to management and custodial fees, consulting fees, transaction costs and other administrative costs chargeable to the System.

The procedures to be undertaken for the investment management of the System's assets are:

1. The Board of Retirement is empowered with ultimate decision-making authority with regard to the development and execution of the System's investment program. Only the Board in its sole discretion can delegate any portion of that decision-making authority.
2. A formal review of the System's investment structure will be conducted annually by the Board.
3. The investments of the System shall be reviewed no less than quarterly and more often as needed to ensure that policy guidelines continue to be appropriate and are met.

Performance objectives shall be determined by the Board for the total fund, each asset class and each investment manager, and the Board shall monitor investment returns on both an absolute and comparative basis. The source of information for these reviews shall come from staff, outside consultants, and investment managers.

## **SECTION 2**

Plan Asset Allocation Guidelines

Approved by the Board for adoption in January 2006, the current asset allocation guidelines are as follows:

	<b>Minimum</b>	<b>Maximum</b>	<b>Target</b>
<u>DOMESTIC INVESTMENTS</u>			
Equities (Russell 3000 Mandate)			
Russell 1000 Index	19.0%	23.0%	21.0%
<i>Core</i>			<i>16.0%</i>
<i>Enhanced</i>			<i>5.0%</i>
Broad Growth	7.0%	9.0%	8.0%
Large Value	12.0%	14.0%	13.0%
Small Growth	2.0%	3.0%	2.5%
Small Value	2.0%	3.0%	2.5%
<b>Total-Domestic Equity</b>			<b>47.0%</b>
Fixed Income (Lehman Universal Mandate)			
Core Index	8.0%	10.0%	9.0%
Active Core	14.0%	17.0%	16.0%
<b>Total-Domestic Fixed</b>			<b>25.0%</b>
<u>INTERNATIONAL INVESTMENTS</u>			
Equities (MSCI ACWI ex US Mandate)			
Passive EAFE	2.5%	4.5%	3.5%
Active Non-US	10.5%	14.5%	12.5%
Emerging Markets	1.0%	3.0%	2.0%
<b>Total International Equities</b>			<b>17.0%</b>
<u>REAL ESTATE/REAL RETURN</u>	3.5%	6.5%	<b>5.0%</b>
<u>ALTERNATIVES</u>	3.5%	6.5%	5.0%
<u>CASH</u>	0.0%	2.0%	<b>1.0%</b>
<u>TOTAL PORTFOLIO</u>			<b>100.0%</b>

## Plan Asset Allocation Characteristics

### EQUITIES

**Core** - designed to track the return of the Russell 1000 Index, an index biased toward large capitalization stocks, within approximately .5% per year. The large stock core portfolio is a low-risk, broadly diversified portfolio with a market-like yield and P/E ratio.

**Enhanced** - designed to provide small incremental returns over the Russell 1000 Index in a very risk-controlled manner.

**Broad Growth** – designed to invest in companies that comprise the broad US equity market. Portfolio is characterized by higher risk, lower yield stocks with P/E ratios higher than the general equity market. The growth stock portfolio will display above market performance in rising markets and equal to or over market performance in down markets.

**Large Value** - designed to outperform the market in down and flat markets, while approximating market performance in up markets. Value portfolios provide participation in companies that are undervalued relative to the market and are usually characterized by high yields and low P/E ratios.

**Small Growth** - designed to invest in companies that reside within the smaller company segment of the US equity market. Portfolio is characterized by higher risk, lower yield stocks with P/E ratios higher than the general equity market. The small growth stock portfolio will typically display above market performance in rising markets and lower-than-market performance in down markets.

**Small Value** - designed to invest in companies that reside within the smaller company segment of the US equity market. Expected to outperform the market in down and flat markets, while approximating market performance in up markets. Small value portfolios provide participation in smaller companies that are undervalued relative to the market and are usually characterized by high yields and low P/E ratios.

## FIXED INCOME

**Core Index** - designed to track the return of the Lehman Universal Index. Assets are invested and reinvested with the objective of achieving a total return approximating the return of the Lehman Universal Index.

**Active Core** – designed to produce a total return that exceeds the Lehman Universal Index. Key focus is on adjusting the maturities, sectors, quality, and coupons of a portfolio of bonds to exploit market opportunities. Average maturity 5 to 10 years.

## INTERNATIONAL

**Passive EAFE** - designed to track the total return of the Morgan Stanley Europe, Australasia and Far East (EAFE) Index. This index consists of stocks in the world's major equity markets outside of North and South America. Typically it includes large capitalization companies in each market representing approximately "70%" of each market. The portfolio is a broadly diversified portfolio with risk and fundamental characteristics similar to that of the EAFE benchmark. The index strategy followed provides low-cost exposure to the benchmark.

**International Active Equities** - focus on equity securities of non-U.S. companies traded on foreign security exchanges and denominated in foreign currencies. International equities provide increased company investment opportunities as well as excellent diversification due to the counter cyclical nature of business and economic trends between the U. S. and other countries.

**Emerging Markets** – focus on equity securities of non-U.S. companies traded on foreign security exchanges, denominated in foreign currencies, located in markets of developing economies such as Argentina, Chile, Jordan, Malaysia, Mexico, Philippines, and Thailand. Emerging markets equities increase the size of and exposure to the investable universe of foreign securities beyond those located in developed markets.

## REAL ESTATE/REAL RETURN

**Real Estate** – focus on providing immediate protection against unexpected inflation, dampening overall portfolio volatility and providing excellent diversification from traditional capital market exposure. Provides equity participation in commercial, industrial, or residential properties and other related opportunities. Participation in this segment of the asset class might include (i) investments in funds that invest directly in real estate properties and/or (ii) investments in publicly traded Real Estate Investment Trusts (REITs) and/or Real Estate Operating Companies (REOCs). Because these latter investments trade in the public markets, they may prove to be more volatile than private real estate. Private real estate returns tend to be more stable because property values change only when they are appraised.

**Real Return** – focus on providing investment returns that consistently exceed inflation, provide principal protection and diversify the portfolio from traditional capital market volatility exposure. Participation in this segment of the asset class might include (i) investment strategies that emphasize inflation-protected securities, (ii) asset allocation strategies that utilize a wide spectrum of asset classes including many real asset classes (e.g., commodities, natural resources, etc.), and/or (iii) other absolute return-oriented strategies. The primary purpose of the Real Return segment is to diversify and augment the Real Estate component by delivering potentially stable, inflation-protected returns.

## ALTERNATIVE

**Alternative Investments** - The Board may review from time to time non-traditional portfolio investments such as venture capital, options, futures, and other new investment vehicles as they become available and meet fiduciary requirements.

## Performance Objectives

The System's performance objectives can be divided into two components: objectives for the overall fund and objectives for the individual portfolio components. Both levels of objectives will be incorporated in quarterly reviews of the System's performance.

The performance objectives for the overall fund are fourfold:

1. Objective relative to asset allocation targets
2. Objective relative to financial plan assumptions
3. Objective relative to inflation
4. Objective relative to actuarial rate of interest

The first objective results in a comparative index that reflects the System's unique asset allocation policy (see Table 1). Exceeding this objective indicates that the active management of the various portfolio components has added value over a passively managed fund with a similar asset mix. The second objective relates actual asset class performance to financial plan assumptions to review the ongoing asset allocation. The inflation objective requires that the investment performance provide an adequate real return over the expected rate of inflation, the primary driver of benefits and, therefore, pension costs. Lastly, the System should earn a return over the assumed actuarial interest rate of 8.16% per year.

Individual portfolio components also have performance objectives reflecting the unique investment style of each category. The investment style and performance benchmarks for the five objectives stated above are shown in Table 2.

Table 1

**FIVE-YEAR PERFORMANCE OBJECTIVES**

at January 2006

OVERALL FUND OBJECTIVES

1. Relative to asset allocation targets, index weighted by:

1%	90-day treasury bills
47%	Russell 3000 Index
25%	Lehman Universal Index
17%	MSCI All Country World ex U.S. (ACWI ex-US) Index
5%	Russell 3000 + 3.0% (illiquidity premium)
<u>5%</u>	NCREIF Real Estate Index
100%	

2. Relative to Financial Plan Assumptions:

<u>Asset Category</u>	<u>Expected Real Rate of Return %</u>
Domestic Equity	7.25%
Domestic Fixed Income	3.00%
International Equity	7.00%
Emerging Markets	9.50%
Real Estate/Real Return	4.50%
Alternatives	10.25%
Cash	1.50%

3. Relative to Inflation:

2.5% in excess of Consumer Price Index

4. Relative to assumed actuarial rate of interest:

Return above 8.16%

Table 2

**OBJECTIVES FOR INDIVIDUAL PORTFOLIO COMPONENTS**

**DOMESTIC INVESTMENTS**

Equities	Russell 3000 Index
Core	Return equal to Russell 1000 Index
Enhanced	1.0% in excess of Russell 1000 Index annually
Broad Growth	1.5% in excess of Russell 3000 Growth over market cycle
Large Value	1.0% in excess of Russell 1000 Value over market cycle
Small Growth	1.5% in excess of Russell 2000 Growth over market cycle
Small Value	1.5% in excess of Russell 2000 Value over market cycle

**FIXED INCOME INVESTMENTS**

Core Index	Return equal to Lehman Universal Index
Active Core	1.0% in excess of Lehman Universal Index

**INTERNATIONAL INVESTMENTS**

Equities	MSCI ACWI ex U.S. Index
Passive EAFE	Return equal to MSCI-EAFE
Active Non-US	2.0% in excess of MSCI-EAFE over 3-5 yr. rolling period
Emerging Markets	2.5% per annum in excess of MSCI-Emerging Markets Free over 3-5 yr. rolling period

**REAL ESTATE**

Real Estate/ Real Return	1.0% per annum in excess of the NCREIF Real Estate Index
-----------------------------	----------------------------------------------------------

**ALTERNATIVES**

Private Equity	Russell 3000 + 3.0% (over period no less than 5 years)
----------------	--------------------------------------------------------

### **SECTION 3**

## Manager Guidelines

Manager guidelines encompass two areas,

- 1) general guidelines applicable to all managers, and
- 2) specific guidelines, including performance objectives unique to each manager.

The general guidelines are:

- ~ Manager investment philosophy, style, and strategy shall remain consistent and shall not change without the express written approval of the Board of Retirement.
- ~ Sector and security selection, portfolio quality and timing of purchases and sales are delegated to the investment manager.
- ~ The following transactions are prohibited: purchase of non-negotiable securities, short sales, selling on margin, and uncovered derivatives transactions. “Uncovered transactions” are such transactions where the collateral supporting the transaction is less than 100% of the notional value of the derivative transaction.
- ~ Transactions that involve a broker acting as a "Principal", where such broker is also the investment manager who is making the transaction is prohibited, except where specifically approved by the Board.
- ~ Transactions shall be executed at the lowest possible cost.
- ~ The use of derivative instruments (“derivatives”) such as options, futures, and other hedging instruments for risk control and sector exposure purposes by the System’s investment managers is permissible subject to specified guidelines (see Investment Manager Guidelines).

## Plan Asset Allocation Managers

To fulfill the asset allocation guidelines, the following investment managers have been selected:

### **DOMESTIC INVESTMENTS**

#### **Equities**

Core

Russell 1000 Index

AllianceBernstein

Enhanced

INVESCO Institutional, Inc.

Broad Growth

Starbuck, Tisdale and Associates

Large Value

AllianceBernstein

Small Growth

Babson

Small Value

DFA

#### **Fixed**

Lehman Universal Core Index

Lehman Brothers Asset Management

Active Core

STW Fixed Income Management

Active Core

Reams Asset Management

### **INTERNATIONAL INVESTMENTS**

#### **Equities**

Passive EAFE

State Street Global Advisors

Active EAFE

NewStar

Fidelity Management Trust Company

Emerging Markets

The Boston Company

### **REAL ESTATE**

Private Real Estate

RREEF

**INVESTMENT MANAGEMENT GUIDELINES AND OBJECTIVES  
FOR  
ALLIANCE BERNSTEIN INSTITUTIONAL INVESTMENT MANAGEMENT**

**RUSSELL 1000 CORE INDEX FUND**

Definition of Manager Style

AllianceBernstein will manage a Russell 1000 Index Fund which will provide equity participation in industry and market capitalization sectors approximately in proportion to their share of the market as represented by the Russell 1000 Index. The goal of the management style is to closely track the performance of the Russell 1000 Index in a portfolio with low turnover.

Portfolio Characteristics

- ~ Price/earnings ratio and yield similar to the Russell 1000 Index.
- ~ Diversification, as represented by an R squared of .99 or greater.
- ~ Risk relative to the market as represented by beta of 1.00.
- ~ Fully invested at all times, i.e., less than 5% in cash reserves.
- ~ No more than 5% of the portfolio may be invested in any one issue unless the security represents more than 5% of the market capitalization of the Russell 1000 Index.
- ~ No issue shall be held in the portfolio if as a result more than 5% of the outstanding shares of such company are held in SBCERS's portfolio.

Performance Objectives

To invest and reinvest assets in the Account with the performance objective of having the investment results approximate the performance of the Russell 1000 Index within + or - 20 basis points annually. In the context of the Account's objective, it is understood that in managing the Account, the Manager will not be required to utilize customary economic, financial, market analyses or other traditional investment management techniques.

**INVESTMENT MANAGEMENT GUIDELINES AND OBJECTIVES  
FOR  
INVESCO, A DIVISION OF AMVESCAP**

**ENHANCED RUSSELL INDEX FUND**

Definition of Manager Style

INVESCO will manage an enhanced equity product that is designed to: (1) outperform the Russell 1000 Index over time and (2) control risk by having a similar overall risk profile as the Russell 1000.

Portfolio Characteristics

The Enhanced Equity product consists of a fully-invested diversified portfolio of equities, and any temporarily uninvested cash is held in a short-term fixed income portfolio.

The Enhanced Equity product uses the INVESCO proprietary Stock Selection Model to generate forecasts of excess return for each stock relative to a universe of approximately 1000 large capitalization, liquid stocks. The return forecasts are combined with risk attributes for each company, provided by BARRA's Risk Model, in an optimizer in order to create a portfolio with the desired relative return/risk characteristics. Required rebalancing trades are implemented at as low a total transaction cost as possible.

In general, the Manager will rebalance the Enhanced Equity product on a monthly basis. However, the Manager will rebalance on an intra-month basis as needed. The targeted number of holdings is 300. The annual targeted turnover is approximately 35%. The maximum over/underweight for each industry, as defined by BARRA, is .50% relative to the Russell 1000 at time of rebalance.

Portfolio Guidelines

The portfolio shall be comprised of cash equivalents and equity securities of companies doing business in the United States with minimum market capitalizations of \$500 million. Equity securities shall be restricted to those issues listed on the New York, American, NASDAQ, or other nationally recognized United States stock exchanges. The portfolio may also contain no more than 5% unleveraged Russell 1000 Index futures for purposes of liquidity and tracking. Use of derivatives for speculation is prohibited.

For prudent diversification the portfolio shall be highly diversified. Diversification will be defined in statistical terms relative to the Russell 1000 Index. The diversification objective is R-Squared, a correlation coefficient squared of 0.95 or better and a standard error of one percent per year. These statistical measures estimate the degree to which the portfolio should follow the Russell 1000 Index and the range of variation of results around the benchmark's expected results.

Performance Objectives

The performance objective of the portfolio will be to generate returns of 100 basis points in excess of the total returns of the Russell 1000 index annually.

**INVESTMENT MANAGEMENT GUIDELINES AND OBJECTIVES  
FOR  
STARBUCK, TISDALE AND ASSOCIATES**

**BROAD GROWTH**

Definition of Manager Style

Starbuck, Tisdale and Associates will manage a portfolio that will add value above a passively managed portfolio using stock selection as the principal tool. Sector rotation and reduction of equity commitment in favor of cash equivalents may be used if such strategies fit in with the manager's assessment of investment values and the market environment for equity investments in general. It is expected these companies will be medium to large firms. The goal of this management style is to equal or outperform the market as measured by the Russell 3000 Growth Index in up markets and to equal or outperform the market in down markets, in keeping with Starbuck, Tisdale's traditional capital conservation orientation.

Portfolio Characteristics

- ~ Price/earnings ratio and yield may vary, but will normally not vary from market P/E and yield of the Russell 3000 Growth Index by more than 20%.
- ~ Risk relative to the market as measured by beta, with few exceptions, will not exceed 1.5.
- ~ Cash position and non-equity exposure may vary at manager's discretion.
- ~ Initial position in any stock may not exceed 5% of portfolio assets.
- ~ No issue shall be held in the portfolio if, as a result,
  - a. more than 10% of the outstanding shares of that company are held by the manager in the total of all its accounts, or,
  - b. more than 5% if the outstanding shares are held in SBCERS' portfolio.

Performance Objectives

1. Equal or exceed Russell 3000 Growth Index in up markets, while equaling or outperforming the same index in down markets.
2. Outperform Russell 3000 Growth by 1.5% or more over a market cycle, defined as 3 to 5 years.
3. Produce above average returns and remain in the top half of a broad manager universe, over a market cycle defined as 3 to 5 years.

**INVESTMENT MANAGEMENT GUIDELINES AND OBJECTIVES  
FOR  
ALLIANCE BERNSTEIN INSTITUTIONAL INVESTMENT MANAGEMENT**

**Large Value**

Definition of Manager Style

AllianceBernstein Institutional Investment Management will manage a value oriented portfolio which will invest in U.S. traded stocks of companies which are undervalued relative to the market in terms of assets, normalized earnings, dividend yields and other appropriate evaluation measures. It is expected these companies generally will be larger firms with established operating records. The goal of this management style will be to outperform the market as represented by Russell 1000 Value index.

Investment Objectives

On a time-weighted total return basis, investment performance is expected to exceed the Russell 1000 Value Index by 1% over a full business cycle.

Investments

Issues will be listed on the New York Stock Exchange, American Stock Exchange, Regional Exchanges or Over-the-Counter markets. ADRs and International Stocks that trade on these U.S. exchanges are also allowed at a maximum of 10% of the portfolio market value in the aggregate.

The active value equity style manager shall have as its guidelines an emphasis on equities producing total return through appreciation and dividend income.

The manager shall have a history of consistent successful value investing. There will be a maximum of 5% cash or cash equivalents in the portfolio excluding cash held in connection with pending purchases and sales, put and call options, margin purchases, letter stock, direct or private placements, or commodities.

Diversification

No more than 5% of the manager's portfolio at cost, and 8% at market value, shall be invested in any one company. No more than 25% of the portfolio at market value shall be invested in any one industry as defined by Standard & Poor's.

Capitalization  
Only Securities of companies with a minimum market capitalization of \$600 million are permissible.

Portfolio Characteristics

The portfolio's price to book will generally be lower than that of the Russell 1000 Value, the price to earnings will generally be lower than the Russell 1000 Value and the dividend yield will generally be higher than the Russell 1000 Value.

Reporting

Formal quarterly reporting will include an accounting statement showing portfolio income, holdings and transactions; a summary of market and portfolio activity including total return statistics; and a statement of the market outlook and investment strategy.

Review Meetings

Review meetings will be held at least annually with the Board. Results as reported by the consultant in relation to objectives; organizational changes during the preceding 12 months; and a review of market and investment strategy will be presented.

**INVESTMENT MANAGEMENT GUIDELINES AND OBJECTIVES  
FOR  
BABSON CAPITAL**

**SMALL GROWTH**

Definition of Manager Style

Babson will manage a portfolio that will add value above a passively managed portfolio using stock selection as the principal tool. Sector rotation and reduction of equity commitment in favor of cash equivalents may be used if such strategies fit in with the manager's assessment of investment values and the market environment for equity investments in general. The portfolio is expected to hold stocks of smaller firms. The goal of this management style is to equal or outperform the small cap growth market as measured by the Russell 2000 Growth Index across all phases of a small cap market cycle.

Portfolio Characteristics

- ~ Price/earnings ratio and yield may vary, but will normally not vary from market P/E and yield of the Russell 2000 Growth Index by more than 20%.
- ~ Risk relative to the Russell 2000 Growth Index as measured by beta, with few exceptions, will not exceed 1.5.
- ~ Cash position and non-equity exposure may vary at manager's discretion.
- ~ Initial position in any stock may not exceed 5% of portfolio assets.
- ~ No issue shall be held in the portfolio if, as a result,
  - a. more than 10% of the outstanding shares of that company are held by the manager in the total of all its accounts, or,
  - b. more than 5% if the outstanding shares are held in SBCERS' portfolio.

Performance Objectives

1. Outperform the Russell 2000 Growth Index by 1.5% or more over a market cycle, defined as 3 to 5 years.
2. Produce above average returns and remain in the top half of a small cap growth manager universe, over a market cycle defined as 3 to 5 years.

**INVESTMENT MANAGEMENT GUIDELINES AND OBJECTIVES  
FOR  
DIMENSIONAL FUND ADVISORS (DFA)**

**SMALL VALUE**

Definition of Manager Style

DFA will manage a portfolio that will add value above a passively managed portfolio using quantitative screening/modeling and proprietary portfolio trading procedures as the principal tools to add value. It is expected that the portfolio will remain fully invested at all times. The portfolio is expected to hold stocks of smaller firms. The goal of this management style is to equal or outperform the small cap value market as measured by the Russell 2000 Value Index across all phases of a small cap market cycle.

Portfolio Characteristics

- ~ Price/earnings ratio and yield may vary, but will normally not vary from market P/E and yield of the Russell 2000 Value Index by more than 20%.
- ~ Risk relative to the Russell 2000 Value Index as measured by beta, with few exceptions, will not exceed 1.5.
- ~ Cash position and non-equity exposure may vary at manager's discretion.
- ~ Initial position in any stock may not exceed 5% of portfolio assets.
- ~ No issue shall be held in the portfolio if, as a result,
  - a. more than 10% of the outstanding shares of that company are held by the manager in the total of all its accounts, or,
  - b. more than 5% if the outstanding shares are held in SBCERS' portfolio.

Performance Objectives

2. Outperform the Russell 2000 Value Index by 1.5% or more over a market cycle, defined as 3 to 5 years.
2. Produce above average returns and remain in the top half of a small cap value manager universe, over a market cycle defined as 3 to 5 years.

**INVESTMENT MANAGEMENT GUIDELINES AND OBJECTIVES  
FOR  
LEHMAN BROTHERS ASSET MANAGEMENT (LBAM)**

**CORE INDEX**

Definition of Manager Style

LBAM will manage a fixed income portfolio indexed against the Lehman Universal Index.

Portfolio Characteristics

The LBAM portfolio will be managed as two risk controlled components. The component representing the investment grade bonds, approximately 85% of the account, will be passively managed to the Lehman Aggregate Index. In this process, LBAM calculates Risk Exposures (expected returns for a 100 basis point change) for the Index and the SBCERS portfolio on at least 31 sector spreads and at least 25 interest rates along the yield curve. The differential between the Risk Exposures of the Index and the SBCERS portfolio are constrained to tightly control the risk. The Aggregate component of the SBCERS portfolio will hold significantly fewer securities than the number included in the Lehman Aggregate Index. The residual of the portfolio approximately 15% of the account, will be approximately equally weighted between high yield and emerging markets debt securities to coincide with their exposures in the Lehman Universal Index.. This residual component will be actively managed in order to manage the additional risks in these sectors of the Index.

LBAM is authorized to invest in any and all securities included in the Lehman Universal Index. In addition, the Manager may invest in other securities that are consistent with those included in the Index. Examples of eligible securities not included in the Index are STRIPS and medium term notes. The SBCERS portfolio will not own more than 2% of any asset backed issuer, or more than 1% of a single corporate issuer.

Portfolio Objectives

LBAM will invest and reinvest assets in the Account with the performance objective of achieving a total return approximating the return of the Lehman Universal Index within + or - 10 basis points annually, net of investment management fees and excluding the initial setup or transition period. Portfolio returns shall be time-weighted using month-end Lehman Universal Index prices.

**INVESTMENT MANAGEMENT GUIDELINES AND OBJECTIVES  
FOR  
STW FIXED INCOME MANAGEMENT**

**ACTIVE CORE**

Definition of Manager Style

STW Fixed Income Management will manage an intermediate-duration fixed-income portfolio designed to protect and increase the fund's income stream. The portfolio will be invested in undervalued market sectors and within these sectors undervalued bonds. Fully priced bonds will be traded for greater numbers of cheaper bonds.

Portfolio Characteristics

The goals of the fund and STW's investment style are such that the following characteristics are expected to be representative of the portfolio:

- ~ ASSET ALLOCATION - Investments will be limited to fixed-income securities and/or cash equivalents.
- ~ MATURITY - The portfolio will be invested in intermediate bonds under most market conditions. Short term investments will typically be less than 10% of assets, but may constitute up to 40% under conditions that are believed to be extremely adverse for fixed-income investment.
- ~ DIVERSIFICATION - The number of issues held will generally be limited when quality spreads are narrow (e.g., fewer than 10). A greater number of issues will generally be held when quality spreads are wide (e.g., 25 or more).
- ~ TURNOVER - The portfolio will be aggressively managed. Turnover will vary based on market conditions and may exceed 300% annually when spreads change and/or markets are active and could be less than 50% when spread relationships are narrow and markets are inactive.
- ~ TYPES OF INVESTMENTS - The portfolios will be invested in fixed-income securities or cash equivalents including, but not limited to: Certificates of Deposit, Bankers Acceptances, commercial paper, money market funds, US Governments, US Government Agencies, corporates, municipals, mortgage passthroughs, asset-backed securities, fixed income derivatives, and other trusts, and sovereign and treaty obligations.
- ~ CURRENCY - All investments will be US-Dollar-denominated or fully hedged into US Dollars.

There are no security-level restrictions placed upon the portfolio either in terms of minimum, maximum or weighted average maturity, quality or coupon, so long as its structure is consistent with its restrictions, goals and objectives as stated elsewhere.

- ~ QUALITY - All securities must be rated, or reflect ratings, in the highest four broad categories (i.e., AAA, AA, A, BBB) by at least one recognized rating service except that securities not receiving a rating may be purchased under the following circumstances:
  - The issue is guaranteed by the US Government, its instrumentalities and/or quasi-agencies.
  - Other similarly ranking debt of the issuer is rated in one of the four broad rating categories by a recognized rating service. STW must believe that, if the issue were submitted to a major rating service, it would receive a rating in one of the highest four rating categories. In this case it would be considered to have received such a rating for the purpose of these investment guidelines.
  - Term commercial paper must be rated A-1 or Prime-1 (the highest rating given such investment by Moody's Investors Service and Standard & Poor's) [*Bank CD and BA standards are currently under review*] or believed, after diligent study, to be deserving of such rating. STW may purchase short-term investment funds approved by the corporate custodian for use in similar funds without applying these tests to each investment in such funds.

- The only bonds that may be purchased which are rated BBB or equivalent are those of regulated public utilities.
- ~ DIVERSIFICATION RESTRICTION - No more than 10% of the assets of the fund, at market value, will be purchased in the securities of any one issuer. Exceptions are US Governments, US Government Agencies, and securities which themselves represent interest in a pool of diversified investments.
- ~ CHANGES IN STATUS - If a security purchased should cease to meet these guidelines, it may be held or swapped for another security of the same issuer. The Dollar value of the holdings of that issuer may not be increased materially by additional purchases.

#### PERFORMANCE OBJECTIVES

To produce a total return that exceeds that of an unmanaged long bond portfolio by 1% annually, measured over a trailing five-year period. STW utilizes the Lehman Aggregate Index as a proxy for the unmanaged portfolio.

**INVESTMENT MANAGEMENT GUIDELINES AND OBJECTIVES  
FOR  
REAMS ASSET MANAGEMENT**

**ACTIVE CORE**

Definition of Manager Style

Reams Asset Management will manage a Core Plus fixed income portfolio with the goal to outperform the Lehman Universal Index using index like risk.

Eligible Investments

Reams Asset Management may invest in U.S. Treasuries and Agencies, U.S. and Yankee corporate bonds, Medium Term Notes, Mortgage pass-through securities (GNMA, FNMA, FHLMC, Savings & Loan, Banks, Whole Mortgages, Commercial Mortgage-Backed), Collateralized Mortgage Obligations (CMOs), Asset-Backed Securities, 144A Securities, Preferred Stock, Convertible Securities, High-Yield securities, non-US Dollar Sovereign Government Bonds, and fixed income derivatives (see below).

Short-term instruments can include U.S. Treasury and Agency issues, Certificates of Deposit and Bankers Acceptances, Repurchase Agreements, Commercial Paper, short corporate notes and Medium term notes, Asset backed securities, and US. money market funds and Bank STIFs.

Portfolio Characteristics

1. The portfolio duration shall be within 33% plus or minus of the benchmark duration.
2. The credit quality of the portfolio should average single A or better.
3. Investments in any single issuer (excluding government and agency issues) may not exceed 5% of the portfolio's market value at the time of purchase.
4. A minimum of 85% of portfolio holdings must be rated at least Baa3 by Moody's or BBB- by Standard & Poor's at the time of purchase.
5. In the event of a downgrade of an investment grade security below Baa3 or BBB-, Reams Asset Management must notify SBCERS about the downgrade and inform of its intention to retain or sell.
6. A maximum of 15% of the portfolio may be in non-U.S. Dollar Sovereign Government holdings at the time of purchase, including positions hedged and unhedged and any securities linked to foreign interest rates.
7. A maximum of 5% of the portfolio may be in derivatives, defined as structured notes with a principal indexing or CMOs of the following types: IOs, inverse IOs, PRNs, inverse PRNs, and POs.
8. Derivatives used for substitution, exposure, risk control, and arbitrage strategies are permitted. Use of derivatives for speculation is prohibited. For non-exchange traded derivatives, counterparty credit status shall be of the highest caliber with care taken to avoid credit guarantees extended through to parties less creditworthy than the primary counterparty in the transaction. Counterparty exposure is limited to firms with a short-term credit rating of at least A1/P1, single counterparty exposure limited to 5% of the cost value of the aggregate portfolio as well as any specific manager portfolio.
9. At no time will the use of leverage be permitted in fixed income portfolios.

Performance Objectives

To outperform the Lehman Universal Index with index like risk by at least 100 basis points over a full market cycle defined as 3 to 5 years.



**INVESTMENT MANAGEMENT GUIDELINES AND OBJECTIVES  
FOR  
STATE STREET BANK & TRUST COMPANY**

**PASSIVE EAFE**

Definition of Manager Style

State Street will manage a portfolio with an MSCI EAFE Index mandate. This portfolio will fully replicate the benchmark index and will minimize transaction costs

Portfolio Characteristics

Fully replicate the MSCI EAFE Index, holding 1120 securities in 20 countries.

Performance Objectives

To provide a rate of return which will match the return of the MSCI EAFE INDEX +/- .5% on an annualized basis.

**INVESTMENT MANAGEMENT GUIDELINES AND OBJECTIVES  
FOR  
NEWSTAR**

**INTERNATIONAL EQUITIES**

Definition of Manager Style

NewStar will manage an international equity portfolio that will typically exhibit a value bias. Stocks are selected using a combination of top-down (market-oriented) bottom-up (security selection) approaches. NewStar's approach emphasizes country markets that exhibit favorable liquidity dynamics and within those markets invests in companies possessing strong valuation and growth fundamentals. NewStar will emphasize larger capitalized stocks.

Portfolio Characteristics

The portfolio shall be diversified to reduce the impact of losses in individual investments. Exposure shall be to a minimum of 60 stocks quoted in at least 10 stock markets, although assets will not be specifically allocated to individual countries or markets.

The portfolio may be invested with a maximum of 100% in common stock and other equity related securities of non-U.S. companies traded on recognized exchanges throughout the world or traded over the counter, if the issuer of such securities has a publicly available operating record of at least three years. The three year requirement will not apply to companies created through mergers, acquisitions, or spin-offs.

The cash equivalent portion should not normally exceed 10% of the portfolio. Cash equivalents may be U.S. dollar or non-U.S. dollar denominated.

Equity investments shall be in companies for which the market value of the outstanding equity at time of purchase exceeds \$500 million.

Not more than 5% of the total value of the portfolio as of the time of purchase and not more than 7% of market value, shall be invested in the equity securities of any one company.

Turnover in the portfolio shall not normally exceed 100% in any twelve month period. Turnover shall be defined as the total dollar value of the lesser of purchases or sales divided by the market value of the portfolio at the beginning of the period.

The portfolio shall not invest in letter or restricted stock, naked options or future contracts, and uncovered short positions or commodities.

Currency hedging up to a maximum of 25% of portfolio value is permitted for defensive purposes. Currency hedging shall be effected through the use of forward currency contracts. Naked hedging is not permitted.

Proxies shall be at the sole discretion of the Manager.

Performance Objectives

The objective of the fund is to exceed the performance of the Morgan Stanley Capital International EAFE Index by 2½% per annum over a rolling 3-5 year period.

**INVESTMENT MANAGEMENT GUIDELINES AND OBJECTIVES  
FOR  
FIDELITY MANAGEMENT TRUST COMPANY**

**INTERNATIONAL EQUITIES**

Definition of Manager Style

International Equity Management with a core-to-growth oriented investment style. Stocks are picked using a fundamental, bottom-up process. A medium to long term total return investment objective will be employed. Emphasis shall be on medium and larger capitalized stocks.

Portfolio Characteristics

The portfolio shall be diversified to reduce the impact of losses in individual investments. Exposure shall be to a minimum of 60 stocks quoted in at least 10 stock markets, although assets will not be specifically allocated to individual countries or markets. Investing in Emerging Markets is prohibited.

The portfolio may be invested with a maximum of 100% in common stock and other equity related securities of non-U.S. companies traded on recognized exchanges throughout the world or traded over the counter, if the issuer of such securities has a publicly available operating record of at least three years. The three year requirement will not apply to companies created through mergers, acquisitions, or spin-offs.

The cash equivalent portion should not normally exceed 10% of the portfolio. Cash equivalents may be U.S. dollar or non-U.S. dollar denominated.

Equity investments shall be in companies for which the market value of the outstanding equity at time of purchase exceeds \$1 billion.

Not more than 5% of the total value of the portfolio as of the time of purchase and not more than 7% of market value, shall be invested in the equity securities of any one company.

Turnover in the portfolio shall not normally exceed 100% in any twelve month period. Turnover shall be defined as the total dollar value of the lesser of purchases or sales divided by the market value of the portfolio at the beginning of the period.

The portfolio shall not invest in letter or restricted stock, naked options or future contracts, and uncovered short positions or commodities.

Currency hedging up to a maximum of 25% of portfolio value is permitted for defensive purposes. Currency hedging shall be effected through the use of forward currency contracts. Naked hedging is not permitted.

Proxies shall be at the sole discretion of the Manager.

Performance Objectives

The objective of the fund is to exceed the performance of the Morgan Stanley Capital International EAFE Index by 2½% per annum over a rolling 3-5 year period. The System retains discretion to evaluate performance of the portfolio using other style-specific international equity indices.

**INVESTMENT MANAGEMENT GUIDELINES AND OBJECTIVES  
FOR  
THE BOSTON COMPANY**

**EMERGING MARKETS**

Definition of Manager Style

The Boston Company will manage an active Emerging Markets Management with a core-to-value oriented investment style. Stocks are picked using a fundamental, bottom-up process. A medium to long term total return investment objective will be employed. Emphasis shall be on medium and larger capitalized stocks.

Portfolio Characteristics

The assets will be invested primarily in common stocks and other equity securities of issuers organized or conducting business in countries other than the United States. Such securities include, but are not limited to, local shares, ADRs, GDRs, securities convertible into stock, preferred stock, 144A private placement securities, rights and warrants. The Fund may also invest in currencies and forward contracts to settle trades and may invest in units of other TBC Pooled Employees Funds for qualified employee benefit plans.

Diversification

- No single holding shall account for more than 5% of the portfolio at market at the time of purchase.
- No single holding shall account for more than 5% of the outstanding common stock of any one corporation.
- Normally, the weighting in any one sector shall not be more than 10 percentage points above the Morgan Stanley Emerging Markets Free Index weighting.
- The Fund will be invested in a minimum of 15 countries.
- Normally, no one country will represent more than the greater of 5 percentage points above the Morgan
- The cash equivalent portion should not normally exceed 10% of the portfolio. Cash equivalents may be U.S. dollar or non-U.S. dollar denominated.
- Currency hedging up to a maximum of 25% of portfolio value is permitted for defensive purposes. Currency hedging shall be effected through the use of forward currency contracts. Naked hedging is not permitted.
- Proxies shall be at the sole discretion of the Manager.

Performance Objectives

The objective of the fund is to exceed the performance of the Morgan Stanley Capital International Emerging Markets Free Index by 2½% per annum over a rolling 3-5 year period. The System retains discretion to evaluate performance of the portfolio using other style-specific international and emerging markets equity indices.

**INVESTMENT MANAGEMENT GUIDELINES AND OBJECTIVES  
FOR  
RREEF**

**RREEF AMERICA II FUND**

Definition of Manager Style

RREEF will manage a commingled fund that will add value above the NCREIF Real Estate using property selection, property income management, and modest financial leverage as the principal tools for adding value. . It is expected the fund's properties will have a fair market values ranging from \$5 million to \$250 million. The goal of this fund is to produce stable long-term returns with the majority of the return coming from property income; property values and lease payments are expected to appreciate to protect against inflation.

Portfolio Characteristics

- ~ Fund is expected to produce an annual cash yield of 6% . Long-term total return target is 9% per year.
- ~ Investment risk is managed through property sector and regional diversification and maintaining prudent levels of financial leverage. It is expected that the fund will be diversified across all major property sectors and regions and will emphasize industrial and office properties due to their potential to offer stable cash yields.
- ~ Cash position and non-real estate exposure may vary at manager's discretion.
  
- ~ Financial leverage, as measured by the fund's loan-to-value ratio, will not exceed 30%.

Performance Objectives

1. Equal or exceed NCREIF Real Estate Index across all phases of a real estate market cycle.
2. Outperform NCREIF Real Estate Index by 1.0% or more over a real estate cycle, typically defined as 5 to 7 years.
3. Produce above average returns and remain in the top half of a universe of private real estate commingled funds, over a market cycle defined as 5 to 7 years.

## **SECTION 4**

## GLOSSARY OF INVESTMENT TERMS

### Indices

**Standard & Poors ("S&P) 500 Equity Index** The most widely used U.S. index of the equity market. The S&P 500 is comprised of 500 large, successful U.S. companies and is constructed to represent movements in common stocks. Stocks are chosen so that in aggregate, they represent a broad distribution by industry group, comparable to that of stocks traded on the New York Stock Exchange. Decisions about stocks to be included and deleted are made by the S&P Index Committee. The S&P 500 represents approximately 75% of the cap-weight of all U.S. stocks.

**Lehman Aggregate Bond Index** A broad proxy for the U. S. taxable bond market. Comprised of publicly-issued non-convertible domestic debt of the U. S. Government, Federal agencies, and industrial, utility, and financial corporations. Mortgage pass-through bonds are also included. The index covers issues of at least one year maturity and quality grades from AAA to Baa. Essentially, the Aggregate Bond Index is equivalent to the Lehman Government/Corporate Bond Index plus mortgages.

**Long Bond Index** A customized proxy for the U. S. long-maturity bond market. Consists of 47.5% of the Lehman Brothers Long Government Bond Index, 47.5% of the Lehman Brothers Long Corporate Bond Index, and 5% of the Merrill Lynch 91-Day Treasury Bill Index.

**Lehman Brothers Long Government Bond Index** A proxy for the U. S. taxable government bond market with long maturities. Minimum maturity is 10 years. Minimum quality rating is AAA. Comprised of publicly-issued non-convertible domestic debt of the U.S. Government and its Federal Agencies.

**Lehman Brothers Long Corporate Bond Index** A proxy for the U. S. taxable corporate bond market with long maturities. Minimum maturity is 10 years. Minimum quality rating is AA-. Comprised of industrial, utility, and financial corporations.

**Merrill Lynch 91-Day Treasury Bill Index** This index is computed by linking monthly the return on 91-day Treasury Bills. The Treasury Bill rate is generally accepted as a proxy for the return on a risk-free asset.

**Morgan Stanley Capital International (MSCI) Europe, Australia, Far East ("EAFE") Index** Morgan Stanley Capital International publishes monthly and quarterly stock market data for major world equity markets. The EAFE Index consists of stocks within the world's major equity markets. The EAFE index typically includes the larger companies in each market, around 60% of each market by value and covers over 1000 companies in total. In addition to national price indices, regional indexes (e.g., Europe) and industry indexes (e.g., automobiles) are included. The reports also contain key valuation data for the markets, such as price-to-earnings ratios and dividend yields.

**Morgan Stanley Capital International (MSCI) Emerging Markets Free** This index contains securities of the following countries which are available to all investors regardless of local status: Argentina, Brazil, Chile, Colombia, Greece, India, Indonesia, Israel, Jordan, Malaysia, Mexico, Pakistan, Peru, Philippines, Poland, Portugal, South Africa, Sri Lanka, Thailand, Turkey and Venezuela.

**National Council of Real Estate Investment Fiduciaries (NCREIF) Property Index** A proxy for the U.S. commercial property market. The NCREIF Property Index contains a broad spectrum of unlevered commercial properties diversified by property sectors and geographic regions.

**Russell 1000 Value Index** This index contains those Russell 1000 securities with a less-than-average growth orientation. It represents the universe of stocks from which value managers typically select. Securities in this index tend to exhibit lower price-to-book and price-earnings ratios, higher dividend yields and lower forecasted growth values than the Growth universe.

**Russell 3000 Growth Index** This index measures the performance of those Russell 3000 Index companies with higher price-to-book ratios and higher forecasted growth values. The stocks in this index are also members of either the Russell 1000 Growth or the Russell 2000 Growth indexes.

**Solomon Brothers Non U. S. Bond Index** A proxy for the global bond market outside the United States. Consists of both Yankee and Eurodollar bonds. Index limited to publicly-issued prime fixed-income securities on major non-U.S. sovereigns.

## **Investment Terms**

**Beta** The beta coefficient measures the anticipated sensitivity of a portfolio to general movements in the broad market. A portfolio whose beta is equal to 1.0 has an expected return, subject to random movements, equal to that of the broad market. A portfolio whose beta is greater than 1.0 would be expected to advance more rapidly than the broad market index in rising markets and decline more rapidly in falling markets. A portfolio having a beta less than 1.0 would usually gain less than the market in rising markets and lose less in falling markets.

**Currency Hedging** Hedging involves altering an international portfolio's exposure to movements in foreign currencies. A portfolio is completely hedged if all anticipated foreign currency cash flows have been sold into the investor's domestic currency at a known exchange rate (typically the forward rate for the appropriate time horizon). Such a tactic eliminates the effects of currencies' impact on a portfolio's performance. Hedging can also be opportunistic in nature. International managers often develop views about how specific currencies will perform relative to other currencies. Depending on their views, managers may over-or-underexpose their portfolios to specific currencies using derivative instruments such as futures, forward contracts, and options.

**Duration** Measures the average time of bond payments, using present value concepts. Because a portfolio's (or bond's) duration can change as a result of shifting interest rates, practitioners use duration to gauge a portfolio's sensitivity to interest rate movements. Portfolios with short durations are less sensitive to changes in interest rates. Portfolios with long durations are more sensitive to interest rate changes.

**Fixed Income Derivatives** Futures, options, and swaps that are designed to match the return and/or cash flow patterns of certain underlying securities. A future is an exchange-traded contract to purchase or sell a security at a pre-set time in the future. An option is an exchange-traded contract to purchase or sell a security at a specified price at a pre-set time in the future. A swap is an agreement between two parties to exchange the cash flows of the two underlying securities. Examples of fixed income derivatives include: interest rate swaps, credit default swaps, interest rate futures, options on interest rate swaps or credit default swaps, futures on interest rate swaps or credit default swaps.

**Price/Earnings ("P/E") ratio** A P/E ratio is a measure of value. It is the value of an investment divided by the projected earnings of the underlying corporate entity. Normally, practitioners describe P/Es on a per-share basis for ease of comparison. P/Es are most often used in equity markets. Practitioners use P/Es both to analyze historical trends and relative valuations. Relatively high P/Es can be a signal of overvaluation or high expected growth. Relatively low P/Es may indicate areas of low earnings growth or undervaluation.

**R-squared** The R-squared statistic measures the extent of the relationship between the broad market and the portfolio. The R-squared statistic ranges from 0.0 to 1.0. An R-squared of 1.0 means that the broad market explains 100% of the portfolio's behavior. An R-squared of 0.0 means there is no relationship between the portfolio and the broad market.