

**STATE COMPENSATION INSURANCE FUND  
INVESTMENT COMMITTEE**

**MINUTES OF OPEN SESSION MEETING**

**January 20, 2011**

The Investment Committee met on January 20, 2011 at One Leidesdorff, Conference Room 3, 344 Pine Street, San Francisco, California.

**AGENDA ITEM 1: CALL TO ORDER AND ROLL CALL**

The meeting came to order at 12:02 p.m. and the following members were present: Chair Senator Michael J. Machado (Ret.); Donald E. Garcia; Thomas E. Rankin; and Francis (Frank) E. Quinlan (Alternate).

There was a quorum.

Also present: Chief Investment Officer Peter Guastamachio; Treasury & Investments Program Manager and Assistant Corporate Secretary Stephanie Chan; Treasury & Investments Manager Maria Quintanilla; Senior Vice President of Finance Ethel Wang; and Staff Counsel David Freitas.

**AGENDA ITEM 2: APPROVAL OF NOVEMBER 18, 2010 OPEN MEETING MINUTES**

Sen. Machado requested a motion to approve the minutes of the November 18, 2010 Open meeting of the Investment Committee as presented.

Sen. Machado requested public comment of which there was none.

MOTION: Mr. Rankin      SECOND: Senator Machado

To approve the minutes of the November 18, 2010 Open meeting of the Investment Committee as presented.

YES: 3                      NO: 0                      Motion carried.

**AGENDA ITEM 3: REVIEW INVESTMENT BENCHMARK**

Peter Guastamachio, Chief Investment Officer, noted that the only changes made to the Investment Policy Statement & Guidelines Resolution included the Resolution Number, which was Resolution No. 951 and has been replaced by Resolution No. 967; the meeting date, which was November 18, 2010 and has been revised to January 20, 2011; and the composition of the benchmarks (Barclay's U.S. Treasury Intermediate Index: which was previously 15% and has been revised to 12.5%, Barclay's U.S. Agency Intermediate Index: which

remained at 15%, Barclay's Taxable Municipal Index: which was previously 10% and has been revised to 12.5%, Barclay's U.S. Corporate A or better Intermediate Index: which was previously 20% and has been revised to 25%, and Barclay's Fixed Rate MBS Index: which was previously 40% and has been revised to 35%).

Mr. Guastamachio discussed a chart that compared the old State Fund Benchmark (2010) to the proposed Benchmark (2011). He noted that the chart for maturities showed a higher benchmark for 2011 because State Fund increased the municipal bond holdings, which tend to have a longer maturity date. He also noted that the chart outlining the benchmark for quality reflects that more corporate bonds will be rated A or lower in 2011 but the overall aggregate rating of the portfolio will not change and that corporate bonds offer higher yields and less cash flow volatility.

Sen. Machado requested a motion to recommend that the Board approve the Investment Benchmark as presented. A copy of Investment Policy Statement and Guidelines Resolution No. 967 is attached to these minutes.

Sen. Machado requested public comment of which there was none.

MOTION: Mr. Rankin                      SECOND: Mr. Garcia

To recommend that the Board approve the Investment Benchmark as presented in Investment Policy Statement and Guidelines Resolution No. 967 as presented.

YES: 3                      NO: 0                      Motion carried.

#### **AGENDA ITEM 4: APPROVAL OF INVESTMENT TRANSACTIONS**

Stephanie Chan, Treasury & Investments Program Manager, recommended that the Investment Committee approve investment transactions from October 1 to November 30, 2010. All investment transactions for this period were made in accordance with the Investment Policy at the time of purchase. During the months of October and November, State Fund purchased 23 securities totaling approximately \$383.8M. During this same time period, State Fund sold 37 bonds for a total of \$307.7 million. Year-to-date through November 30, 2010, State Fund recognized a net capital gain of approximately \$21.2M. The book value of State Fund's portfolio as of November 30, 2010 was approximately \$18.8B.

Sen. Machado requested public comment of which there was none.

After presentation of the Bond Transactions report, the following actions were taken:

MOTION: Mr. Garcia                      SECOND: Mr. Rankin

To approve and recommend that the Board of Directors ratify the Bond Transactions for the period of October 1 through November 30, 2010.

YES: 3                      NO: 0                      Motion carried.

Ms. Chan presented the Compliance Report indicating that all of State Fund's investments were in compliance with the Investment Policy and met certain minimum credit rating standards at the time of purchase. There were no changes to the Report since the July 2010 meeting. The three out-of-compliance bonds are Southern California Public Power Authority, Rancho Cucamonga, and the State of Oregon, totaling \$139M, or less than 1% of State Fund's investment portfolio. Ms. Chan also noted that the Southern California Public Power Authority bond will not show up in the compliance report at the next meeting. This is because this bond was originally out of compliance because it exceeded the 0.5% "Per Issuer" limit under the previous guidelines. However, the per issuer limit for highly rated bonds (double A or better) has been increased from 0.5% to 1% effective 1/1/11.

Sen. Machado requested public comment of which there was none.

After presentation of the Compliance Report, the following actions were taken:

MOTION: Mr. Rankin                      SECOND: Mr. Garcia

To approve and recommend the Board of Directors ratify the Compliance Report for the period of October 1 through November 30, 2010.

YES: 3                      NO: 0                      Motion carried.

#### **AGENDA ITEM 5: MARKET OUTLOOK /ECONOMIC UPDATE**

Peter Guastamachio, Chief Investment Officer, presented the U.S. Market Outlook and Economic Update. Mr. Guastamachio discussed that corporate earnings are strong and tax incentives for corporations are helping to stimulate the economy. Manufacturing is an area that shows potential for growth and expansion in 2011 since well established companies are planning to build new plants and tax credits for buying equipment are helping this job sector. However, there may be difficulties in filling manufacturing jobs since job seekers may find it difficult to relocate if they are still unable to sell homes that have declined significantly from their purchase value.

Mr. Guastamachio discussed that QEII is not working and although this policy was intended to suppress long-term interest rates and create demand for loans, it is showing little evidence of succeeding. In actuality, it has weakened the dollar, failed to keep rates low, and caused inflation abroad. Other countries are viewing our current economic policies as irresponsible and this makes them more reluctant to invest in U.S. Treasury bonds. He also mentioned that the Fed has targeted inflation at or above 2% in the next two to three years. Another concern is that the Credit Rating Agencies may reevaluate the U.S. country rating in the next twelve months, which could prove even more problematic for the economy if our rating is downgraded or put on negative outlook.

Housing still remains an area of concern and it is predicted that 2011 and 2012 will see substantial foreclosures. Delinquencies on loans reached 9.13% by the end of the 3<sup>rd</sup> quarter in 2010 and foreclosures for the same time period reached 4.39%. Foreclosures will increase in 2011 because banks found that a high percentage of their mortgage paperwork was incomplete or incorrect and had to put things on hold in order to straighten this out. It is anticipated that in 2011, the banks will begin moving forward on foreclosures, which could drive real estate prices down anywhere from 8% to 25%.

Unemployment is still high at 9.4% and although jobless claims are improving, these are still recessionary figures. There were 108,000 jobs a month created in 2010, which works out to 1.29 million jobs for the year. The forecast is that 180,000 jobs a month will be created in 2011. However, approximately 250,000 jobs a month would need to be created to offset the current number of jobless claims and lower the unemployment rate.

Mr. Guastamachio presented an analysis of where interest rates are going. The prediction for 2011 is that Fed Funds will not move much since Fed rates tend to move with unemployment. Review of the Treasury Curve Comparison chart shows that as of 9/30/10, QEII has failed to keep the curve low and it has actually moved back up as of 11/30/10 and further up as of 1/18/11. The consensus forecast based on current market yield is that Fed Funds will move up 75 bps to 1% in the 2<sup>nd</sup> quarter of 2012 but will not return to the 2006 peak level of 5% in the foreseeable future. The current forecast is that 10 year Treasuries will rise by 76 bps while 30 year Treasuries will rise 59 bps.

Today many investment managers are focusing on shorter duration to be prepared for higher inflation in a couple of years which is when they will be able to invest funds at higher yields. Currently they are buying 15 year mortgages and shorter collateralized mortgage obligations. Additionally, Mr. Guastamachio mentioned that Meredith Whitney predicted that the municipal market will encounter numerous defaults by the end of the 2<sup>nd</sup> quarter of 2011 due to credit concerns and budget shortfalls. Mr. Guastamachio stated that most analysts feel she is rather pessimistic but acknowledge that municipal bonds will be a volatile sector this year. Sovereign risk is another major concern and could affect the

overall corporate bond market. Mr. Guastamachio pointed out that subordinated debt risk in the financial sector will be viewed as higher risk as subordinated debt holders may participate in losses similar to equity holders. He also mentioned that we do not need to worry about inflation until the 2<sup>nd</sup> half of 2011 or later. Currently inflation is very low at 0.8% but the consensus forecast for inflation is 1.2% in two years. However, the Federal Reserve's predicts that the 2% inflation target rate will be achieved by late next year.

**AGENDA ITEM 6: PUBLIC COMMENT ON APPROPRIATENESS OF CLOSED SESSION FOR ITEMS 8 THROUGH 9**

Senator Machado requested public comment of which there was none.

The Investment Committee immediately convened into Closed Session.

**AGENDA ITEM 10: CALL TO ORDER AND ROLL CALL**

The meeting was called to order at 1:49 p.m. following the conclusion of the Closed Session and the following Members were present: Sen. Michael Machado (Ret.) Chair; Donald E. Garcia; Thomas E. Rankin; and Francis (Frank) E. Quinlan (Alternate).

There was a quorum.

Also present: President Tom Rowe; Acting Chief Financial Officer Dan Sevilla; Chief Investment Officer Peter Guastamachio; Treasury & Investments Program Manager and Assistant Corporate Secretary Stephanie Chan; Treasury & Investments Manager Maria Quintanilla; Senior Vice President of Finance Ethel Wang; and Staff Counsel David Freitas.

**AGENDA ITEM 11: COMMITTEE MEMBER PRESENTATIONS**

Senator Machado asked if there were any presentations from the Committee members, of which there were none.

**AGENDA ITEM 12: PROPOSALS AND SUGGESTIONS FOR MARCH 17, 2011 AGENDA**

Senator Machado asked if there were any additional recommendations from the committee for the March 17, 2011 agenda, of which there were none.

**ADJOURNMENT**

There being no further business before the Investment Committee, the meeting adjourned at 1:50 pm.

Respectfully submitted,

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Stephanie Chan  
Assistant Corporate Secretary

BOARD OF DIRECTORS

STATE COMPENSATION INSURANCE FUND

INVESTMENT POLICY STATEMENT & GUIDELINES RESOLUTION

WHEREAS, the Board of Directors of the State Compensation Insurance Fund (State Fund) is required to invest and reinvest the moneys of the State Fund which are in excess of current requirements in securities authorized by law for the investment of funds of private insurance carriers, in accordance with Sections 11787 and 11797 of the Insurance Code; and

WHEREAS, the State Fund is a non-tax paying entity; and

WHEREAS, the opportunities to acquire or dispose of such securities are such that it is impracticable to obtain the advice and determination of the Board in advance of each separate transaction; and

WHEREAS, the Board deems it to be prudent policy to establish standards which can be applied administratively to the selection and purchase of securities; and

RESOLVED, by the Board of Directors of the State Fund in regular meeting assembled at San Francisco on January 20, 2011 that:

- A. All purchases must meet the following criteria and any further detailed criteria for the specific mandate.
  - 1. The preservation of State Fund's principal and surplus, while maximizing income, will be the primary and underlying criteria for the selection and retention of securities.
  - 2. State Fund assets will be managed and controlled in a manner consistent with prudent business practices.
  - 3. The long-term objective is to exceed established benchmarks.
  
- B. The President or Chief Investment Officer, and in their absence, either the Chief Financial Officer or Chief Risk Officer, are hereby authorized to purchase or sell, exchange, or otherwise dispose of at the market, securities which are authorized by law for the investment of the funds of private insurance carriers provided the type of security to be acquired is described hereafter in this section and meets the conditions and standards set forth in Sections C, D, E and F as approved by the Board of Directors. Any Investment Manager approved by the Board of Directors and under contract with State Fund may purchase and sell securities on behalf of State Fund per the terms, limitations and guidelines set forth in this INVESTMENT POLICY STATEMENT & GUIDELINES RESOLUTION under the primary direction of the Chief Investment Officer and, in his/her absence, the direction of the aforementioned officers in this section.
  
- C. Long Term Fixed Income Investments

Allowable securities include the following assets and with Board approval can include other asset classes as allowed under applicable regulations.

  - 1. Bonds, notes, certificates of indebtedness, or other obligations for which the faith and credit of the United States of America are pledged.

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2. Obligations of US Government Agencies and Government Sponsored Entities (GSEs).
3. Obligations of the Dominion of Canada, or of any province of the Dominion of Canada, or obligations for which are pledged the faith and credit of the Dominion of Canada, or of any province or city of the dominion which are payable in US dollars.
4. Mortgage-backed securities (MBS) issued by the US Government Agencies and GSEs, including pass-throughs, PAC CMOs (Planned Amortization Class Collateralized Mortgage Obligations), TAC CMOs (Targeted Amortization Class Collateralized Mortgage Obligations), VADM CMOs (Very Accurately Defined Maturity Collateralized Mortgage Obligations) and Sequential pay CMOs, but excluding such mortgage derivatives as inverse floaters, interest only strips, principal only strips, and "support bonds." No direct sub-prime or Alt-A MBS are allowed.
5. Publicly traded fixed income securities issued by a corporation organized under the laws of the United States or any State thereof including securities issued under Rule 144(a).
6. General obligations of any State for which the faith and credit of the State are pledged for the payment of principal and interest.
7. Obligations issued under authority of law by any county, municipality, or school district in any State, or in any province of the Dominion of Canada or in any political subdivision of the Commonwealth of Puerto Rico, including bonds of any county water district.

**D Cash and Cash Equivalents**

Maintain short-term funds to obtain a reasonable level of earnings by participating in the following:

1. Bonds, notes, certificates or indebtedness, or other interest bearing obligations for which the full faith and credit of the United States of America are pledged.
2. Obligations of US Government Agencies and GSEs.
3. Commercial Paper issued by a corporation organized under the laws of the United States or any State.
4. Certificates of Deposit (CDs) issued by domestically chartered banks and savings and loans. The institution's charter is acceptable if granted by a state or national regulatory body. This includes domestically chartered branches of foreign banks, commonly referred to as Yankees.
5. Mutual Fund(s) that reflect similar criteria to those listed in D.1. through D.4.
6. State Treasurer's Pooled Money Investment Fund (PMIF).
7. Interest-bearing bank accounts.

**E. Credit Rating Standards and Limitations**

1. To monitor compliance, the investment manager will assign a credit rating to each security using the following logic: a) If one nationally recognized statistical rating



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- organizations (NRSRO) rates the security, the rating will apply; b) If two NRSRO rate the security, the lower rating will apply; c) If all three NRSRO rate the security, the second lowest will apply; d) When considering the credit rating of the municipal securities, the higher of the financial guarantor or the underlying credit will be used.
2. The weighted credit rating of the fixed income portfolio shall average at least Aa2/AA/AA, at Moody's, S&P and Fitch, respectively, at all times.
  3. There is no per issuer limit of US Treasuries and US Agencies.
  4. The investment manager shall not purchase corporate securities rated below A2/A/A by two or more NRSRO without prior approval of the Chief Investment Officer.
  5. The purchase of split-rated corporate securities where the lowest rating is A3 or A- is permitted only upon consent of the Chief Investment Officer before purchase (example: A3/A/A or A2/A/A-).
  6. Single corporate issuer rated Aa3/AA- or better may not exceed 1.00% of the book value of the portfolio. Single corporate issuer rated below Aa3/AA- may not exceed 0.75% of the book value of the total portfolio, including the Cash Management Holdings. Only those holdings in each manager's positions exceeding the thresholds as of April 1, 2009 that resulted from the division of the portfolio are exempt from this limitation.
  7. Corporate securities in aggregate shall not exceed 45% of the total portfolio, including the Cash Management Holdings.
  8. The investment manager shall not purchase municipal securities rated below A2/A/A by two or more NRSRO without prior approval of the Chief Investment Officer.
  9. The purchase of split-rated municipal securities where the lowest rating is A3 or A- is permitted only upon consent of the Chief Investment Officer before purchase (example: A3/A/A or A2/A/A-).
  10. Single municipal issuer rated Aa3/AA- or better may not exceed 1.00% of the book value of the portfolio. Single municipal issuer rated below Aa3/AA- may not exceed 0.75% of the book value of the total portfolio, including the Cash Management Holdings. Only those holdings in each manager's positions exceeding this threshold as of April 1, 2009 that resulted from the division of the portfolio are exempt from this limitation. Ultimate credit obligor will be used to define a single municipal issuer.
  11. Municipals in aggregate shall not exceed 20% of the total portfolio, including the Cash Management Holdings.
  12. The aggregate total of corporates and municipals shall not exceed 55% of the total portfolio, including the Cash Management Holdings.
  13. MBS issued by the US Government Agencies and GSEs shall comprise no more than 45% of the total portfolio, including the Cash Management Holdings. No single MBS pool may exceed 1.00% of the total portfolio, including the Cash Management Holdings. MBS will include all Agency MBS, CMOs and CMBS for the aforementioned limits.
  14. No single Canadian political subdivision may exceed 0.75% of the book value of the portfolio. Canadian political subdivisions in aggregate shall not exceed 5% of the total portfolio, including the Cash Management Holdings.

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15. Securities issued and/or guaranteed by the US Government, US Agencies, and GSEs are recognized as Aaa/AAA entities if they have not been otherwise rated by the rating agencies.
16. Securities issued and/or guaranteed by the Government of Canada and political subdivisions must be rated Aa3/AA- or better by a NRSRO.
17. Securities issued and/or guaranteed by a State or political subdivision must be rated A3/A- or better by a NRSRO.
18. Securities issued by a qualifying corporation must be rated A3/A- or better by a NRSRO.
19. When calculating the sector limits, the Cash Management Holdings will be included. This number may be provided to the Investment Manager on a monthly basis.
20. 15% or more of the portfolio shall be maintained in securities maturing in five years or less.
21. The duration of the portfolio will be managed within a strategic range of 3.0 to 6.5, which is reviewed and approved by the Board annually. An operational target within the duration range will be established and reviewed by the Chief Investment Officer periodically.
22. The performance of the portfolio will be compared to the return of the benchmark noted in section F. At a minimum, the benchmark will be reviewed and reauthorized by the Board on an annual basis.
23. Purchases of Commercial Paper must be rated A1/P1 by two nationally recognized rating services and split rating is not allowed. Eligible Commercial Paper may not exceed 180 days' maturity, or represent more than 10 percent of the outstanding paper of an issuing corporation. No single Commercial Paper issuer may exceed 10% of the Total Cash Management Holdings. Eligible Commercial Paper is further limited to issuing corporations having shareholders' equity in excess of \$10 Billion. Commercial Paper holdings are limited to a maximum of 70% of the Total Cash Management Holdings.
24. Shares in any one mutual fund may not exceed 3% of State Fund's total assets, or 50% of the total Cash Management Holdings, whichever is less. Total investment in all mutual funds may not exceed 7% of State Fund's total assets.
25. The terms for any CDs should never exceed a year. CDs per issuer may not exceed \$50 million or 10% of the total Cash Management Holdings. CDs are further limited to issuing corporations having shareholders' equity in excess of \$10 Billion. CD holdings are limited to a maximum of 30% of the Total Cash Management Holdings. CD issuers must be rated A1/P1 by two nationally recognized rating services.
26. Balances maintained in the PMIF will be monitored regularly by the Cash Management Unit of Fiscal & Investment Services, and reported to the Cash Management and Investment Committee on a monthly basis.
27. If any of the above mentioned rules are breached, the Investment Manager will conduct an analysis and present it with a recommendation to the Chief Investment Officer.

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F. Performance Benchmark

1. The benchmarks are for individual mandates and the overall portfolio for fixed income is Barclay's U.S. Treasury Intermediate Index: 12.5%, Barclay's U.S. Agency Intermediate Index: 15%, Barclay's Taxable Municipal Index: 12.5%, Barclay's U.S. Corporate A or better Intermediate Index: 25%, and Barclay's Fixed Rate MBS Index: 35%.

RESOLVED, that this Resolution No. 967 shall replace Investment Resolution No. 951 effective January 1, 2011.