

TAB 1

**POINT PAPER**  
**ALTERNATIVE ASSET MANAGEMENT PRESENTATION**  
**NOVEMBER 2, 2009**

**ISSUE:** Commission requested that the Boards of Trustees for the City's Pension Plans seek ways to mitigate volatile stock market conditions.

**BACKGROUND:** The Board of Trustees of the General Employees' Pension Plan authorized its investment manager to perform a search for qualified companies to provide alternative asset management opportunities for the Plan's asset portfolio.

After completing the search, Morgan Smith Barney representatives Charlie Mulfinger and Mike DeGenova selected three qualified companies for the Board to interview. On October 16, 2009 the Board interviewed the companies and tentatively selected the company best suited to follow the Board's investment philosophy and past investment practices.

Should Commission agree with the proposed alternative investment opportunity, the Board of Trustees will then consider an ordinance amending the Plan and make a recommendation to the Commission. The Board will also amend the Plan's Investment Policy to establish a maximum 10% investment of the portfolio in alternative asset classes.

# Graystone Consulting

## **Ordinance Review – Permitting More Flexible Asset Allocation!**

Charles H. Mulfinger, II, CIMA  
Managing Director  
Institutional Consulting Director  
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# Asset Allocation Components

## ➤ Assets Classes

- Traditional – Stocks, Bonds, Cash
- Alternatives – Private Real Estate, Hedge Funds, Private Equity, Managed Futures, Structured Products

## ➤ Inputs

- Expected Returns
- Expected Volatility – Standard Deviation
- Asset Correlations

# Traditional Asset Allocation – Risk / Return Expectations

Risk / Return Characteristics		Current Target	Traditional (65%/35%)	Traditional (70%/30%)
ILLUSTRATIVE PERFORMANCE	Expected Return	7.7%	7.7%	7.9%
	Risk	10.8%	10.6%	11.4%
	Sharpe Ratio	0.34%	0.34%	0.33%
	Probability of Loss in Any Given Year	23.6%	23.5%	24.5%
	Probability of 8.45% ROR - Any Given Year	47.3%	47.2%	47.9%
	Probability of 8.45% ROR - 5 Years	42.1%	41.8%	43.0%
	Probability of 8.45% ROR - 10 Years	38.8%	38.5%	40.1%
	Probability of 8.45% ROR - 20 Years	34.4%	33.9%	36.2%
Asset Allocation			Add REITs	Increase Large Cap Equities
Cash & Bonds	Cash			
	US Bonds	35.0%	35.0%	30.0%
	Cash & US Bonds	35.0%	35.0%	30.0%
Equities	US Large Cap Equities	35.0%	32.5%	37.5%
	US Mid Cap Equities	10.0%	10.0%	10.0%
	US Small Cap Equities	10.0%	10.0%	10.0%
	International Equities	8.0%	8.0%	8.0%
	Emerging Market Equities	2.0%	2.0%	2.0%
	REITS		2.5%	2.5%
	Total Equities	65.0%	65.0%	70.0%
More Liquid Alternatives	Relative Value Arb/Event Driven Hedge Funds			
	Long/Short Equity/Hedge Funds			
	Global Macro Hedge Funds/Managed Futures			
	Total More Liquid Alternatives	0.0%	0.0%	0.0%
Illiquid Alternatives	Private Real Estate			
	Leverage Buyouts			
	Ventura Capital			
	Total Illiquid Alternatives	0.0%	0.0%	0.0%
	TOTAL ASSETS	100.0%	100.0%	100.0%

IMPORTANT: The projections and other information generated by the MSSB Portfolio Asset Allocation Tool regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results and are not a guarantee of

# Asset Allocation Thoughts

## FOCUS for Asset Allocation

- Understand relationship of Asset Allocation and Funding
- Prepare portfolio for **all** market conditions
- Improve probability of meeting objectives
  - ✓ Participate in up markets
  - ✓ Perform in sideways market
  - ✓ Preserve capital in down market

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**Are We Relying to Much on Beta?**

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# Question of the day...

“How’s the market doing?”

*Is it prudent to base the funding of your pension plan on the answer to this question?*



# Decade to Date Returns

## Paradigm Shift for Investors

Traditional asset classes are expected to produce returns that are below historical norms. **Traditional assets alone most likely *WILL NOT* meet the investment objectives of the investor.**

Index	1/1/00 to 6/30/2009	1/1/00 to 6/30/2009
	Annualized Return	Annualized Std. Dev.
60% S&P/40% BC Agg	0.89%	10.07%
BC Agg	6.24%	3.62%
S&P 500	-3.10%	17.45%
S&P 100	-4.41%	17.43%
Russell 1000	-2.67%	17.90%
Russell 3000	-2.38%	18.16%
MSCI EAFE (NET)	-0.87%	21.19%

# What's Wrong With Beta?

After all, equities go up in most time periods:

Calendar Year Analysis			
Rolling 3 Year Periods			
Index	Down	Total	%
S&P 500	13	81	16.05%
Russell 3000	4	28	14.29%
BC Agg	0	31	0.00%
Rolling 5 Year Periods			
Index	Down	Total	%
S&P 500	11	79	13.92%
Russell 3000	3	26	11.54%
BC Agg	0	29	0.00%
Rolling 7 Year Periods			
Index	Down	Total	%
S&P 500	5	77	6.49%
Russell 3000	1	24	4.17%
BC Agg	0	27	0.00%
Rolling 10 Year Periods			
Index	Down	Total	%
S&P 500	3	74	4.05%
Russell 3000	1	21	4.76%
BC Agg	0	23	0.00%
<b>S&amp;P = 1926-2008</b> <b>Russell 3000 = 1979-2008</b> <b>BC Agg = 1976-2008</b>			

13 negative 3 year periods:  
 Worst 1929 – 1931 = **-27.00%**  
 "Recent" Worst 2006 – 2008 = **-8.40%**  
*Only 6 negative periods since Dec. 1942*

11 negative 5 year periods:  
 Worst 1928 – 1932 = **-12.50%**  
 "Recent" Worst 2004 – 2008 = **-2.20%**  
*Only 6 negative periods since Dec. 1941*

5 negative 7 year periods:  
 1926 – 1932 = **-3.30%**  
 1928 – 1934 = **-3.50%**  
 1929 – 1935 = **-3.10%**  
 1968 – 1974 = **-1.50%**  
 2002 – 2008 = **-1.50%**

3 negative 10 year period:  
 1929-1938 = **-0.90%**  
 1930-1939 = **-0.10%**  
 1999-2008 = **-1.40%**

Past performance is not indicative of future results

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**Are There Alternatives?**

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# The Paradigm Shift

*“...Move away from heavy reliance on domestic marketable securities, emphasizing instead a collection of asset classes expected to provide equity-like returns driven by fundamentally different underlying factors.*

*These asset allocation changes expose the portfolio to a range of less efficiently priced alternatives creating a rich set of active management opportunities.”*

David Swensen- Chief Investment Officer, Yale University

Pioneering Portfolio Management: An Unconventional Approach to Investment

*Published January 2000*

# Large College Endowments Are Heavily Invested In Alternatives...

Portfolio Allocation and Corresponding Portfolio Performance

Endowment Size	Portfolio Allocations <sup>(a)</sup>		Portfolio Returns	
	Traditional	Alternatives	5 Year	10 Year
> \$1.0 b	52%	48%	13%	10%
> \$500m - ≤ \$1b	59%	41%	11%	8%
> \$100m - ≤ \$500m	71%	31%	10%	6%
> \$50 - ≤ \$100m	79%	21%	9%	6%
> \$25 - ≤ \$50m	82%	18%	8%	5%
≤ \$25m	91%	9%	7%	5%

Source: National Association of College and University Business Officers (NACUBO) 2008 study of 778 institutions published 1/24/2009. Five (5) year returns cover the period from June 2003 to June 2008. Ten (10) year returns cover the period from June 1998 to June 2008. However, this study does not indicate how much of the portfolio returns were attributable to the allocation to alternatives. Note: The larger the endowment, the better the ability to diversify. Past performance does not guarantee future results. Real results may vary. <sup>(a)</sup> "Traditional" includes Equity, Fixed Income and Cash. "Alternatives" include Real Estate, Hedge Funds, Private Equity, Venture Capital, Natural Resources and Other.

# ...And Diversified Across a Broad Spectrum of Alternative Asset Classes

## Portfolio Allocations

Assets	Equity	Fixed Income	Cash	Real Estate	Hedge Funds	Private Equity	Venture Capital	Natural Resources	Other	Total Traditionals	Total Alternatives
> \$1.0 B	39%	11%	1%	6%	23%	10%	4%	5%	1%	52%	48%
> \$500MM - < \$1B	43%	15%	2%	6%	19%	8%	3%	4%	2%	59%	41%
>100 < \$500MM	50%	17%	3%	4%	16%	4%	1%	3%	2%	70%	30%
>\$50 < \$100MM	54%	20%	4%	4%	12%	2%	1%	2%	1%	79%	21%
>25 - < \$50MM	58%	21%	3%	4%	10%	1%	0%	1%	1%	82%	18%
< \$25MM	56%	27%	8%	2%	3%	1%	0%	0%	2%	91%	9%

## Portfolio Returns

Assets	1-yr	3-yr	5-yr	10-yr
> \$1.0 B	0.6%	12.0%	13.3%	9.5%
> \$500MM - < \$1B	-1.9%	9.6%	11.4%	7.6%
>100 < \$500MM	-2.9%	8.5%	10.1%	6.4%
>\$50 < \$100MM	-3.2%	7.4%	9.3%	5.8%
>25 - < \$50MM	-4.3%	6.6%	8.4%	5.1%
< \$25MM	-4.1%	5.7%	7.2%	4.8%

Source: National Association of College and University Business Officers (NACUBO) 2007 study of 778 institutions published 1/24/2009. One (1) year returns cover the period from June 2007 to June 2008. Three (3) year returns cover the period from June 2005 to June 2008. Five (5) year returns cover the period from June 2003 to June 2008. Ten (10) year returns cover the period from June 1998 to June 2008. However, this study does not indicate how much of the portfolio returns were attributable to the allocation to alternatives. Note: The larger the endowment, the better the ability to diversify. Past performance does not guarantee future results. Real results may vary. "Traditional" includes Equity, Fixed Income and Cash. "Alternatives" include Real Estate, Hedge Funds, Private Equity, Venture Capital, Natural Resources and Other

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# Why Absolute Return?

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# Traditional Investment Process

- Primary determinant of return is the market (Beta)
- Attempt to provide an incremental return versus a benchmark (Alpha)
- Publicly traded securities
- Long only investment policy
- Leverage not included in the process
- Asset based fee structure
  - ✓ Compensation increases through asset growth

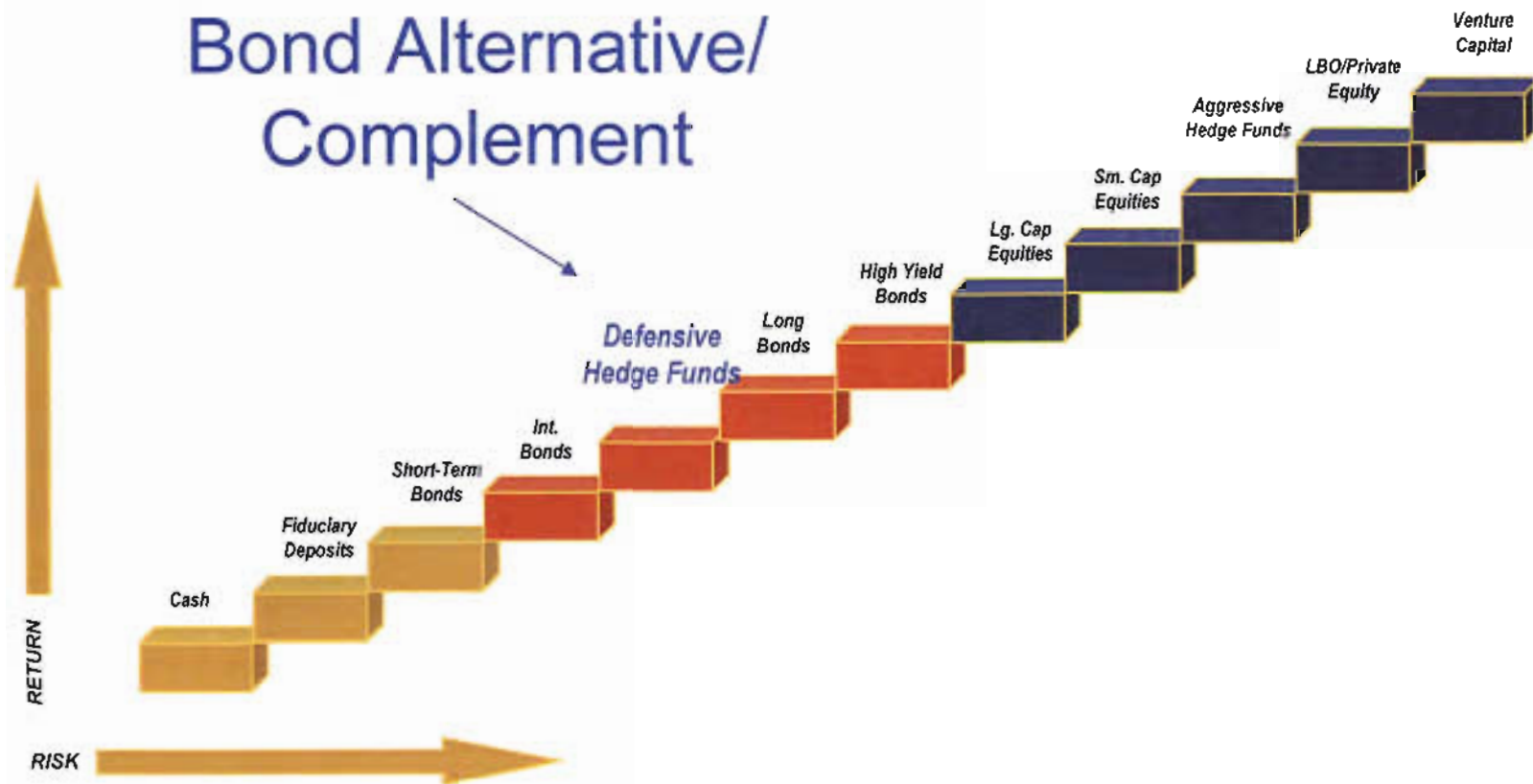


# Hedge Fund Investment Process

- Primary determinant of return is manager skill
- Use investment & risk management tools to seek positive returns regardless of market direction
- Traditional asset classes plus alternative classes
- Balance long and short positions to obtain market neutrality
- Leverage may be utilized to enhance return potential, however it is not a necessary component of hedge fund investing
- Performance based fee structure
  - ✓ Compensation increases through higher absolute returns

# Alternative Strategies Cover a Wide Range of Risk Classifications

The Risk-return Staircase  
Bond Alternative/  
Complement



# Asset Allocation

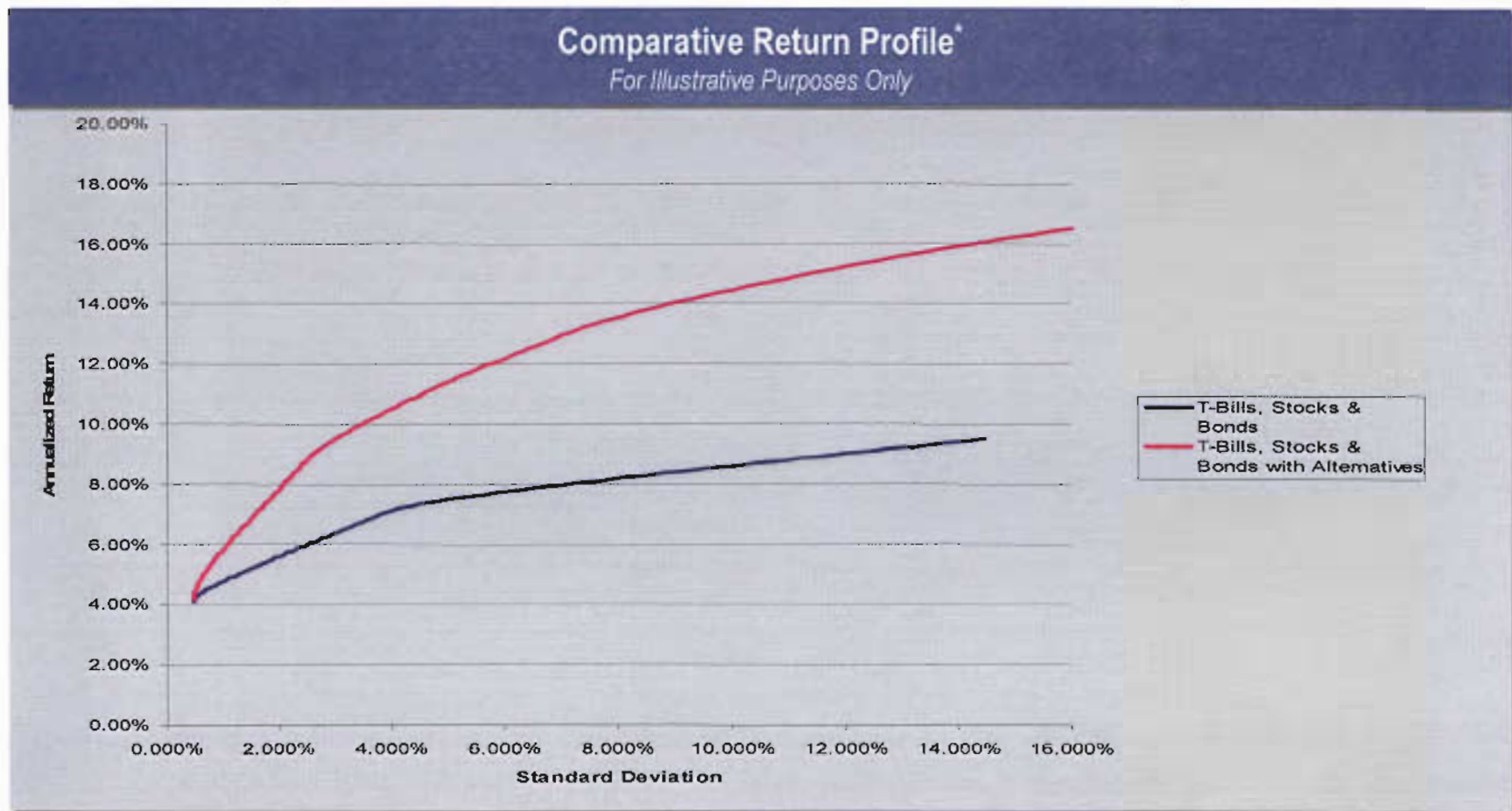
## – Impact of Adding Absolute Return

Risk / Return Characteristics		Traditional (65%/35%)	Traditional/ Alternative (60%/30%/10%)	Traditional/ Alternative (60%/25%/15%)
ILLUSTRATIVE PERFORMANCE	Expected Return	7.7%	7.9%	8.0%
	Risk	10.6%	10.4%	10.5%
	Sharpe Ratio	0.34%	0.36%	0.37%
	Probability of Loss in Any Given Year	23.5%	22.6%	22.5%
	Probability of 8.45% ROR - Any Given Year	47.2%	47.8%	48.1%
	Probability of 8.45% ROR - 5 Years	41.8%	43.3%	44.0%
	Probability of 8.45% ROR - 10 Years	38.5%	40.5%	41.5%
	Probability of 8.45% ROR - 20 Years	33.9%	36.7%	38.1%
Asset Allocation		Add REITs	Increase Funds of Hedge Funds	Add Private Real Estate
Cash & Bonds	Cash			
	US Bonds	35.0%	30.0%	25.0%
	Cash & US Bonds	35.0%	30.0%	25.0%
Equities	US Large Cap Equities	32.5%	27.5%	27.5%
	US Mid Cap Equities	10.0%	10.0%	10.0%
	US Small Cap Equities	10.0%	10.0%	10.0%
	International Equities	8.0%	8.0%	8.0%
	Emerging Market Equities	2.0%	2.0%	2.0%
	REITS	2.5%	2.5%	2.5%
	Total Equities	65.0%	60.0%	60.0%
More Liquid Alternatives	Relative Value Arb/Event Driven Hedge Funds		2.0%	2.0%
	Long/Short Equity/Hedge Funds		4.0%	4.0%
	Global Macro Hedge Funds/Managed Futures		4.0%	4.0%
	Total More Liquid Alternatives	0.0%	10.0%	10.0%
Illiquid Alternatives	Private Real Estate			5.0%
	Leverage Buyouts			
	Ventura Capital			
	Total Illiquid Alternatives	0.0%	0.0%	5.0%
	TOTAL ASSETS	100.0%	100.0%	100.0%

IMPORTANT: The projections and other information generated by the MSSB Portfolio Asset Allocation Tool regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results and are not a guarantee of

# Historical Impact

Historically, Adding Alternative Investments To Traditional Portfolios May Have Resulted In Enhanced Risk Adjusted Returns



\*Source: Equity: S&P 500 Index. Bonds: Lehman Aggregate Bond Index. Leveraged Buyouts: Venture Economics (pooled, time weighted returns). Hedge Funds: HFRi Fund of Funds Index. Real Estate: NCREIF National Property Index. Managed Futures: CISDM Index. Note: The portfolios were calculated with the latest data available as of Feb 24, 2009. Average Returns and volatilities of Cash, U.S. Bonds, U.S. Large Cap Equities, Managed Futures and Hedge Funds are based on historical returns from January 1990 through December 31, 2008. Average returns and volatilities of Leveraged Buyouts and Real Estate are based on historical returns from January 1990 through September 30, 2008. Past performance does not guarantee future results. Real results may vary.

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# **Absolute Return Search**

## **– Funds of Hedge Funds**

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Performance as of August 31, 2009

	Private Advisors Stable Value Fund LTD	HFRI FOF: Conservative Index	S&P 500
Strategy	Multi-Strategy FOF		
Volatility	Lower		
Minimum Investment (Initial)	\$1,000,000		
Firm Assets	\$3.4 Billion		
# Key Personnel	15		
Standard Management Fee	1.25%		
Consulting Management Fee	1.25%		
<b>Performance Since 11/1/01</b>			
Annualized Return	6.31%	3.16%	1.47%
Standard Deviation	4.06%	4.63%	15.79%
Alpha	4.18%		-3.21%
Up/Down Capture vs. Mrkt	109.30%	46.20%	175.4% / 230.7%
Incentive Fee	None		
Hurdle Rate	N/A		
Lock-up Period (1)	1 Year		
Liquidity Period (2)	Annual (notice given by last business day of Oct)		
Holdback % (3)	10%		

(1) Lock-up Period = No redemption allowed, or fee charged, during period

(2) Liquidity Period = When redemptions are allowed

(3) Holdback % = % of redemption proceeds not paid until next audit completed

# Zephyr StyleADVISOR

Zephyr StyleADVISOR: Graystone Consulting

Manager vs Benchmark: Return through August 2009

(not annualized if less than 1 year)

	YTD	1 year	3 years	5 years	7 years	10 years
Private Adv Stable Value Fd Ltd A	7.66%	-5.01%	1.50%	4.18%	7.18%	7.84%
S&P 500	14.97%	-18.25%	-5.78%	0.49%	3.59%	-0.79%
Barclays Capital U.S. Aggregate	4.63%	7.95%	6.35%	4.96%	5.04%	6.31%
HFRI FOF: Conservative Index	7.03%	-10.84%	-1.42%	1.98%	3.20%	4.21%

## Calendar Year Return

As of August 2009

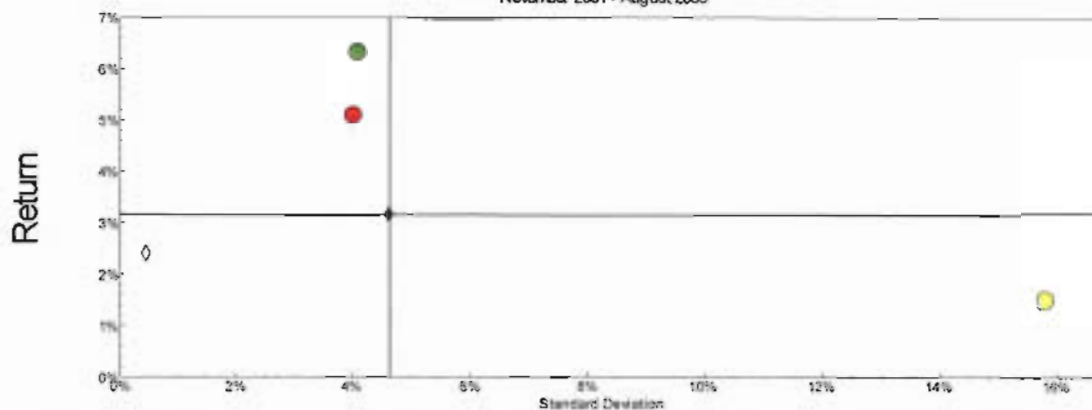
	YTD	2008	2007	2006	2005	2004	2003	2002	2001	2000
Private Adv Stable Value Fd Ltd A	7.66%	-13.63%	8.78%	9.13%	6.30%	15.17%	15.17%	2.68%	8.41%	17.74%
S&P 500	14.97%	-37.00%	5.49%	15.79%	4.91%	10.88%	28.68%	-22.10%	-11.88%	-9.11%
Barclays Capital U.S. Aggregate	4.63%	5.24%	6.96%	4.33%	2.43%	4.34%	4.11%	10.27%	8.42%	11.63%
HFRI FOF: Conservative Index	7.03%	-19.87%	7.67%	9.21%	5.15%	5.82%	9.01%	3.58%	3.11%	5.77%

# Zephyr StyleADVISOR

Zephyr StyleADVISOR: Graystone Consulting

Manager Risk/Return  
Single Computation

November 2001 - August 2009



- Private Adv Stable Value Fd Ltd A
- S&P 500
- Barclays Capital U.S. Aggregate
- ◆ Market Benchmark:  
HFRI FOF: Conservative Index
- ◇ Cash Equivalent:  
Citigroup 3-month T-bill

## Risk-Return Table

November 2001 - August 2009: Annualized Summary Statistics

	Return (%)	Std Dev (%)	Beta vs. Market	Alpha vs. Market (%)	R-Squared vs. Market (%)	Shape Ratio	Observs.
Private Adv Stable Value Fd Ltd A	6.31	4.06	0.6566	4.18	55.95	0.9644	94
S&P 500	1.47	15.79	1.8562	-3.21	29.60	-0.0586	94
Barclays Capital U.S. Aggregate	5.11	3.96	0.0170	5.13	0.04	0.6851	94
HFRI FOF: Conservative Index	3.16	4.63	1.0000	0.00	100.00	0.1663	94



# Zephyr StyleADVISOR

Zephyr StyleADVISOR: Graystone Consulting

## Up/Down Table

November 2001 - June 2009. Single Computation

	# of Months		Average Return (%)		Average Return (%) vs. Market		1-Year (%)		Market Benchmark (%)		
	Up	Down	Up	Down	Up Market	Down Market	Best	Worst	Up Capture	Down Capture	R-Squared
Private Adv Stable Value Fd Ltd A	77	15	0.89	-1.52	0.91	-0.55	17.37	-15.06	107.8	46.2	55.53
S&P 500	57	35	2.77	-4.21	1.38	-3.10	38.52	-43.32	161.3	230.7	29.03
Barclays Capital U.S. Aggregate	59	33	1.06	-0.77	0.40	0.40	11.69	-0.81	46.5	-33.3	0.01
HFRI FOF: Conservative Index	66	26	0.84	-1.26	0.84	-1.26	11.27	-19.87	100.0	100.0	100.00

# Disclosures

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