WURTS ASSOCIATES

MEMORANDUM

To: **Board of Trustees, Fresno County Employees' Retirement Association**

From: **Jeffrey MacLean, Wurts & Associates**

Date: **January 29, 2009**

Re: **Revised Asset Allocation and Rebalancing Recommendation**

The purpose of this memorandum is to recommend a revision to the asset allocation policy and to advise the Board on rebalancing the portfolio to fund the forthcoming Opportunistic Fixed Income and TIPs mandates.

The asset allocation policy recommended by Wurts & Associates and adopted by the Board of Trustees allocated 9% to Hedge Fund of Funds. Wurts & Associates recommends trimming this allocation to 5%.

The rational for this recommendation is twofold. First, the dramatic changes in the capital markets during the last six months of 2008 make traditional investments much more attractive relative to hedge funds. Second, hedge funds will certainly experience a re-rationalization as institutional investors grapple with the Madoff scandal, deleveraging, and their lower liquidity. While Wurts & Associates doesn't rule out a 9% allocation for FCERA sometime in the future, we believe the current environment makes the revised allocation much more prudent. Many of these issues were discussed in our memorandum to clients dated November 14th. I have enclosed a copy of that memorandum for your reference.

Wurts' 2009 long term expected returns (10 year) for large capitalization U.S. equities has been increased from 8.20% to 9.25%. This 1.05% increase is the result of more favorable valuations from recent market declines. Credit strategies have also become much more attractive as we have increased Wurts' high yield 10 year expected returns by 5.50% over our 2008 assumption. At the same time, we have lowered our hedge fund assumption by 25 basis points, from 7.5% to 7.25%.

Therefore, Wurts & Associates recommends reallocating the 4% from Hedge Fund of Funds as follows:

- 1% into large capitalization domestic equity, increasing the allocation from 24% to 25%.
- 1% into emerging market equity, increasing the allocation from 2% to 3%.
- 1% into global fixed income, increasing the allocation from 1% to 2%.
- 1% into opportunistic fixed income, increasing the allocation from 6% to 7%.

The net effect of these changes as well as Wurts' revised capital market assumptions is that the expected return of the portfolio increases from 8.55% to 8.91% with lower expected volatility –

changing from 11.47% to 11.21%. The lower allocation into hedge funds also lowers the amount of potential "headline" risk in the portfolio.

Enclosed is a Rebalancing Recommendation exhibit that includes the revised policy and the actual allocation as of 12/31/08. The exhibit indicates that there is little rebalancing required in the equity component of the portfolio except for international small cap which should be deferred until the due diligence phase of the implementation is complete. However, given the imminent allocation to TIP's and Opportunistic Fixed Income, the Board needs to rebalance some the fixed income assets to fund these mandates.

Consistent with our recommendation last year, Wurts & Associates recommends eliminating Bradford & Marzec from the manager structure to fund the Opportunistic and TIPs mandates. While the liquidity in the fixed income markets haven't materially improved, Wurts & Associates believes the opportunities within these two mandates justify incurring the heightened transaction costs. Wurts & Associates further recommends that the most illiquid securities within the Bradford portfolio be transferred in kind to the other fixed income managers where we could use more liquid securities to fund the new mandates.

Please feel free to call me anytime at 310.297.1777 should you have any questions about this recommendation.

WURTS ASSOCIATES

MEMORANDUM

To: **Wurts & Associates Clients**

From: **Eric Petroff, CFA, Director of Research**

Date: **November 14, 2008**

Re: **Hedge Fund Conundrum**

Hedge funds stand out in the capital markets universe as the one broadly accepted investment that cannot be defined as an asset class. This is because hedge funds do not represent any sort of systematic risk exposure such as stocks or bonds, but instead represent a myriad of strategies that repackage and leverage various investments and derivatives. This of course is why they are so complicated and difficult to understand for even sophisticated institutional investors.

Nonetheless there are some very simple factors that can affect hedge fund returns, especially during these tumultuous times in capital markets. Having given considerable thought to these factors, we are beginning to form some concerns about prospective returns for hedge funds.

Our first concerns relates to the overall deterioration of credit markets and resulting financial de-levering. Because hedge funds are leverage (or debt) hungry entities, credit market conditions are making access to leverage more costly and difficult. Furthermore because markets have corrected so sharply, many hedge funds are being forced to de-lever positions in what could be described as in industry wide "margin call." The HFR fund of funds index is posting double digit losses thus far in 2008 and managers could reasonably be expected to continue reducing leverage in anticipation of continued capital markets weakness or volatility. This then leads us to our second area of concern – industry cash flows.

Setting aside credit issues and their affect on returns, we must not fail to consider the potential effects of cash flows in and out of hedge funds. If you examine the hedge fund industry's cash flows over time, you will find there has only been one year where flows were negative. This was in 1994 when the industry lost more than $1 billion[1] (or about 0.70% of assets). In just the 3rd quarter 2008 *alone,* hedge funds had net outflows of $32 billion[2] (or 2% of industry assets). The reasons for these outflows are not specifically known, but they probably relate to investors views on prospective returns and portfolio rebalancing. What is important to understand though is cash outflows could force de-levering and selling during a down market, potentially serving as a downward drag on hedge fund performance. So logically one must consider potential cash flows in the hedge fund industry, which we believe will be driven by two primary factors.

[1] Source: HFR
[2] Source: HFR

The first is hedge funds relative attractiveness to other asset classes such as equities and bonds. The primary argument for hedge funds over recent periods is they would provide equity like returns with less volatility in an environment when equities were relatively overpriced. So they seemed like a good idea from a risk/return standpoint. However, equity markets worldwide have corrected anywhere from 40-60% from their highs and valuations are cheaper now than in many years. On top of this, credit spreads have risen substantially, pushing prospective returns for diversified fixed income investments well into the high single digits. So one driving factor to hedge fund allocations has just been removed.

Secondly there is the mechanical aspect of portfolio rebalancing. Even though hedge funds have lost substantial amounts of money, their losses are nothing in comparison to equity markets. As clients review their portfolios relative to target allocations, institutions across the country will be pulling assets from hedge funds to place in cheaper equity markets. After all, hedge funds have served their purpose of protecting assets from a strong downturn in equity markets. Of course if equity markets rebound strongly, this would be much less of a concern, but we have no way of knowing if this is going to happen. Still, the hedge fund industry does seem poised for a period of declining assets.

So here is where the conundrum comes into play. If you believe hedge funds are headed towards near term pain through de-levering and withdrawals, do you really want to get caught up selling during a forced de-levering environment…well, probably not. On the other hand, do you want to miss out on buying traditional investments which will likely outperform hedge funds over the next ten years…well, probably not.

Our conclusions in this regard are broad and need specific application to your portfolio. If you portfolio has a relatively modest allocation to hedge funds, say less than 10%, it is probably in your best interests to maintain this position and perhaps engage in some modest rebalancing. One way or the other, the absolute size of the allocation changes between hedge funds and other assets will have a very modest impact on returns. On the other hand, if you have a large allocation to hedge funds (15-25%), then it would be best to analyze the potential cost of exiting during an inopportune time against the benefit of buying much cheaper traditional assets. Chances are this analysis will lead to the conclusion of liquidating a meaningful portion of the hedge fund allocation and placing those assets in public markets.

We understand these conclusions may sound a little "wishy-washy," but the reality is we are currently faced with highly unpredictable capital markets conditions given the severity of the economic environment, as well as the potential, unpredictable effects of government intervention. Our primary goal therefore is to reduce poorly compensated risk in the face of this uncertainty. We believe hedge funds now fall into that category.

Fresno County Employees' Retiement Association
Rebalance Recommendation as of 12/31/2008

Asset Class	Manager	Actual $	Actual %	Target %	Target $	Rebalance Estimate	Rebalance Recommendation	New $	New %	Variance to Targets (%)
Domestic Large Cap										
LCC	S&P 500 FLAGSHIP	$112,629,441	5.2%	5.0%	$107,822,033	($4,807,408)	$0	112,629,441	5.2%	**0.2%**
LCG	INTECH	$113,116,210	5.2%	5.0%	$107,822,033	($5,294,176)	$0	113,116,210	5.2%	**0.2%**
LCG	RUSSELL 1000G Index	$71,069,627	3.3%	5.0%	$107,822,033	$36,752,407	$0	71,069,627	3.3%	**-1.7%**
LCV	AJO	$138,037,078	6.4%	5.0%	$107,822,033	($30,215,044)	$0	138,037,078	6.4%	**1.4%**
LCV	WELLINGTON	$111,653,521	5.2%	5.0%	$107,822,033	($3,831,488)	$0	111,653,521	5.2%	**0.2%**
Total Large Cap		$546,505,876	25.3%	25.0%	$539,110,166	($7,395,710)	$0	546,505,876	25.3%	**0.3%**
Domestic Small Cap										
SCG	Kalmar	$82,748,918	3.8%	4.0%	$86,257,627	$3,508,709	$0	82,748,918	3.8%	**-0.2%**
SCV	Brandywine	$92,719,584	4.3%	4.0%	$86,257,627	($6,461,958)	$0	92,719,584	4.3%	**0.3%**
Total Small Cap		$175,468,502	8.1%	8.0%	$172,515,253	($2,953,249)	$0	175,468,502	8.1%	**0.1%**
International Equity										
INT'L Large	Templeton	$151,956,734	7.0%	6.0%	$129,386,440	($22,570,294)	$0	151,956,734	7.0%	**1.0%**
INT'L Large	Oechsle	$111,639,546	5.2%	6.0%	$129,386,440	$17,746,894	$0	111,639,546	5.2%	**-0.8%**
INT'L Small	TBD	$0	0.0%	6.0%	$129,386,440	$129,386,440	$0	0	0.0%	**-6.0%**
EMG MKTS	Mondrian	$103,345,123	4.8%	3.0%	$64,693,220	($38,651,903)	$0	103,345,123	4.8%	**1.8%**
Total International		$366,941,403	17.0%	21.0%	$452,852,540	$85,911,137	$0	366,941,403	17.0%	**-4.0%**
Total Equity		$1,088,915,781	50.5%	54.0%	$1,164,477,959	$75,562,178	$0	1,088,915,781	50.5%	**-3.5%**
Fixed Income										
US CoreFI	Blackrock	$222,430,340	10.3%	4.67%	$100,633,898	($121,796,443)	$0	222,430,340	10.3%	**5.6%**
US CoreFI	Bradford & Marzec	$192,420,086	8.9%	0.0%	$0	($192,420,086)	($192,420,086)	0	0.0%	**0.0%**
US CoreFI	Loomis Sayles	$157,931,225	7.3%	4.67%	$100,633,898	($57,297,327)	$0	157,931,225	7.3%	**2.7%**
US CoreFI	WAMCO	$198,986,080	9.2%	4.67%	$100,633,898	($98,352,182)	$0	198,986,080	9.2%	**4.6%**
Opp. FI	TBD	$0	0.0%	7.00%	$150,950,847	$150,950,847	$149,291,273	149,291,273	6.9%	**-0.1%**
Global FI	GMO	$64,330,423	3.0%	2.0%	$43,128,813	($21,201,610)	$0	64,330,423	3.0%	**1.0%**
Total Fixed Income		$836,098,154	38.8%	23.0%	$495,981,353	($340,116,801)	($43,128,813)	792,969,341	36.8%	**13.8%**
Real Assets	As of 9/30	$98,220,615	4.6%	11.0%	$237,208,473	$138,987,858	$43,128,813	141,349,428	6.6%	**-4.4%**
Hedge Funds	As of 9/30	$14,524,115	0.7%	5.0%	$107,822,033	$93,297,918	$0	14,524,115	0.7%	**-4.3%**
Private Equity	As of 9/30	$118,682,000	5.5%	7.0%	$150,950,847	$32,268,847	$0	118,682,000	5.5%	**-1.5%**
Total Assets		$2,156,440,665	100.0%	100.0%	$2,156,440,664	($0)	$0	2,156,440,665	100.0%	**0.0%**

***$43.1 million into Real Assets represents the 2.0% allocation into TIP's**