



Agenda

POST RETIREMENT HEALTH BENEFITS TRUST AGREEMENT ADVISORY BODY

August 4, 2011
8:30 A.M.

651 Pine Street, 11th Floor, Martinez

Robert Campbell, Auditor-Controller - Chair
Lisa Driscoll, County Finance Director
Patrick Godley, HSD Chief Financial Officer
David Twa, County Administrator
Russell Watts, Treasurer-Tax Collector

Agenda Items:

Items may be taken out of order based on the business of the day and preference of the Committee

1. Introductions
2. Public comment on any item under the jurisdiction of the Committee and not on this agenda (speakers may be limited to three minutes)
3. Quarterly Report Review
4. Standardized Report Format for Board of Supervisors
5. Next meeting – November 3

☺ *The Post Retirement Health Benefits Trust Agreement Advisory Body will provide reasonable accommodations for persons with disabilities planning to attend Committee meetings. Contact the staff person listed below at least 72 hours before the meeting.*

📁 *Any disclosable public records related to an open session item on a regular meeting agenda and distributed by the County to a majority of members of the Committee less than 96 hours prior to that meeting are available for public inspection at 651 Pine Street, 10th floor, during normal business hours.*

✉ *Public comment may be submitted via electronic mail on agenda items at least one full work day prior to the published meeting time.*

For Additional Information Contact:

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Glossary of Acronyms, Abbreviations, and other Terms (in alphabetical order):

Contra Costa County has a policy of making limited use of acronyms, abbreviations, and industry-specific language in its meetings and written materials. Following is a list of commonly used language that may appear in oral presentations and written materials associated with meetings:

AB	Assembly Bill	HCD	(State Dept of) Housing & Community Development
ABAG	Association of Bay Area Governments	HHS	Department of Health and Human Services
ACA	Assembly Constitutional Amendment	HIPAA	Health Insurance Portability and Accountability Act
ADA	Americans with Disabilities Act of 1990	HIV	Human Immunodeficiency Syndrome
AFSCME	American Federation of State County and Municipal Employees	HOV	High Occupancy Vehicle
AICP	American Institute of Certified Planners	HR	Human Resources
AIDS	Acquired Immunodeficiency Syndrome	HUD	United States Department of Housing and Urban Development
ALUC	Airport Land Use Commission	Inc.	Incorporated
AOD	Alcohol and Other Drugs	IOC	Internal Operations Committee
BAAQMD	Bay Area Air Quality Management District	ISO	Industrial Safety Ordinance
BART	Bay Area Rapid Transit District	JPA	Joint (exercise of) Powers Authority or Agreement
BCDC	Bay Conservation & Development Commission	Lamorinda	Lafayette-Moraga-Orinda Area
BGO	Better Government Ordinance	LAFCo	Local Agency Formation Commission
BOS	Board of Supervisors	LLC	Limited Liability Company
CALTRANS	California Department of Transportation	LLP	Limited Liability Partnership
CalWIN	California Works Information Network	Local 1	Public Employees Union Local 1
CalWORKS	California Work Opportunity and Responsibility to Kids	LVN	Licensed Vocational Nurse
CAER	Community Awareness Emergency Response	MAC	Municipal Advisory Council
CAO	County Administrative Officer or Office	MBE	Minority Business Enterprise
CCHP	Contra Costa Health Plan	M.D.	Medical Doctor
CCTA	Contra Costa Transportation Authority	M.F.T.	Marriage and Family Therapist
CDBG	Community Development Block Grant	MIS	Management Information System
CEQA	California Environmental Quality Act	MOE	Maintenance of Effort
CIO	Chief Information Officer	MOU	Memorandum of Understanding
COLA	Cost of living adjustment	MTC	Metropolitan Transportation Commission
ConFire	Contra Costa Consolidated Fire District	NACo	National Association of Counties
CPA	Certified Public Accountant	OB-GYN	Obstetrics and Gynecology
CPI	Consumer Price Index	O.D.	Doctor of Optometry
CSA	County Service Area	OES-EOC	Office of Emergency Services-Emergency Operations Center
CSAC	California State Association of Counties	OSHA	Occupational Safety and Health Administration
CTC	California Transportation Commission	Psy.D.	Doctor of Psychology
dba	doing business as	RDA	Redevelopment Agency
EBMUD	East Bay Municipal Utility District	RFI	Request For Information
EIR	Environmental Impact Report	RFP	Request For Proposal
EIS	Environmental Impact Statement	RFQ	Request For Qualifications
EMCC	Emergency Medical Care Committee	RN	Registered Nurse
EMS	Emergency Medical Services	SB	Senate Bill
EPSDT	State Early Periodic Screening, Diagnosis and treatment Program (Mental Health)	SBE	Small Business Enterprise
et al.	et ali (and others)	SWAT	Southwest Area Transportation Committee
FAA	Federal Aviation Administration	TRANSPAC	Transportation Partnership & Cooperation (Central)
FEMA	Federal Emergency Management Agency	TRANSPLAN	Transportation Planning Committee (East County)
F&HS	Family and Human Services Committee	TRE or TTE	Trustee
First 5	First Five Children and Families Commission (Proposition 10)	TWIC	Transportation, Water and Infrastructure Committee
FTE	Full Time Equivalent	VA	Department of Veterans Affairs
FY	Fiscal Year	vs.	versus (against)
GHAD	Geologic Hazard Abatement District	WAN	Wide Area Network
GIS	Geographic Information System	WBE	Women Business Enterprise
		WCCTAC	West Contra Costa Transportation Advisory Committee

Schedule of Upcoming Meetings

November 3, February 2, May 3, August 2, November 1

PARS: County of Contra Costa

Second Quarter 2011

**Presented by
Andrew Brown, CFA**

DISCUSSION HIGHLIGHTS

- We used the majority of the second quarter of 2011 to “average in” to the market the initial \$51 million contribution received in February 2011. As we progressed towards the end of June, we began to reach our targeted asset allocation of 22% large cap equity, 7% mid-cap equity, 7% small cap equity, 8% global equity, 7% international equity, 5% real estate, 41% fixed income (of which 3% allocated to high yield bond) and 3% cash/money market. The Plan received a \$5.6 million contribution (9% of Plan assets) on June 30, which inflated the quarter ending cash position.
- In the second quarter, the Plan returned 0.6%, which underperformed the Plan benchmark return of 1.36%. In a quarter that provided plenty of uncertainty between European sovereign debt issues, the end of quantitative easing II, continuation of the recovery from the nuclear reactor accident in Japan, and continued volatility in commodity prices, our strategy of “averaging in” the initial contribution to the market felt like the correct strategy. The end of the quarter provided a tight distribution range for asset class returns. REIT holdings were the leading area for the Plan, returning 3.88%. Bonds, as measured by the Barclay’s Capital Aggregate Index returned 2.3%. The MSCI-EAFE Index (international equities) returned 1.57%. After these three asset classes, the distribution of returns narrowed considerably with Russell Mid-Cap Index returning 0.41%, MSCI-ACWI (global equities) 0.24%, Russell 1000 Index 0.12%, and cash returned 0%. The only asset class to register a negative return from a benchmark standpoint was small cap stocks, with the Russell 2000 Index returning -1.61%. The drag from our cash holdings, as well as an underweight to fixed income, had the largest impact on the underperformance relative to the Plan benchmark during the second quarter. Our underperformance within the individual holdings that comprise our large cap core allocation also detracted from performance. Given the staging in strategy, we never fully got to an overweight position in any one specific asset class during the quarter, however our investments in mid-cap equities, global equities and real estate were additive to performance. Our underweight in small cap stocks, coupled with our “relative” outperformance in this sector also supported returns.
- Domestic equities. The Russell 1000 Index returned 0.12% for the second quarter. In many respects, it seemed like a hard fought three months to reap only 0.12%. After starting off with a strong April, the market slipped into a six week losing streak. During this time, market watchers were fond of stating that our economy had entered a ‘soft patch’. This soft patch was represented in weaker-than-expected economic readings. Certainly, the non-farm payroll growth in May (+25,000) and June (+54,000) were highly disappointing. Additionally, GDP statistics during the 1st quarter (+1.8%) were highly disappointing. Higher gas prices and supply disruptions from the Japanese tsunami and earthquake, coupled with the continued woes in the housing market, wore on investor’s nerves. On the other hand, there are signs that this soft patch might only be temporary in nature, given the fact that we continue to see strong corporate earning results being generated. A further positive development is that Japan seems to be getting “back on line” with many factories beginning to return to higher levels of capacity. The end of the quarter also marked the end of Quantitative Easing II (QE2). This program, where by the Fed purchased \$600 billion in U.S. Treasuries, coincided with a very strong run for the stock market. Thus, with the end of the program upon us, some investors were nervous about life, post-QE2. While some of the weakness we saw during the middle of the quarter might have been impacted by the end of QE2, we would offer that the stock market has fully discounted the end of QE2.
- The large cap core equity holdings declined -1.41% during the quarter compared to the Russell 1000 Index return of 0.12%. Most of the underperformance was attributable to stock selection, particularly in the financial, consumer discretionary, healthcare and information technology sectors. The largest detractors for the quarter included Suncor Energy (-12.6%), Google (-13.6%), JP Morgan Chase (-10.7%), Wells Fargo (-11.1%), and Greenhill & Co. (-17.5%). Other factors that influenced performance during the quarter included sector allocation, which had a modest negative impact on overall performance. While the strategy benefitted from being underweight financials, performance was more than offset by an overweight in energy and an underweight in both consumer staples and utilities. Positions sold during the quarter included the Hanover Group (-8.9%) and Staples (-14.1%). At the sector level, as of quarter end, the most significant overweights included energy, materials, industrials, consumer staples, and information technology. The largest underweights were in the consumer discretionary, financials, and telecommunications sectors.

DISCUSSION HIGHLIGHTS

- Driven by the uncertainty in the market, defensive sectors were the strongest performers during the second quarter. The top three performing sectors in the Russell 1000 Index were Healthcare (+7.8%), Utilities (+6.1%), and Consumer Staples (+5.3%). The bottom three sectors were Financials (-5.9%), Energy (-4.6%), and Technology (-1.4%). Large cap growth outperformed large cap value during the quarter (0.8% vs. -0.5%) as the large weighting in the financial sector (26.7%) dragged down the average large cap value fund. In the Plan, we maintained a slight tilt in our allocation to large cap value (5.25% to 3.5%) relative to large cap growth.
- Our investment in the Harbor Capital Appreciation Fund (large cap growth) was a highlight in the quarter. The fund returned 3.63% and ranked in the 2nd percentile of large cap growth funds as measured by Morningstar. Holdings from the consumer sector drove returns for the quarter such as Lululemon (+25.6%), Tiffany & Co. (+27.8%), Green Mountain Coffee (+38.2%), and Burberry Group (+23.7%) leading the way. Being underweight financials also helped the fund, although one of the three financial holdings they maintained, American Express (+14.4%) helped returns. The other large cap growth fund, the T. Rowe Price Growth Fund was in-line with the benchmark return, posting a 0.06% return.
- As mentioned previously, the sizable allocation that large cap value funds typically maintained in financial related holdings played a large role in the underperformance relative to the Russell 1000. The T. Rowe Price Equity Income Fund was positioned at 19% at quarter end, while the Loomis Sayles Value Y Fund had a 21.6% allocation to financial stocks. The T. Rowe Equity Income Fund was down -0.95% for the quarter, and the Loomis Fund was off -1.06%.
- Our Mid-Cap equities registered a 0.89% return for the quarter, compared the Russell Mid-cap Index return of 0.41%. On a relative basis, the HighMark Geneva Mid-Cap Growth Fund's return of 0.63%, placed it in the 42nd percentile in Morningstar's mid-cap growth universe. On the other hand, while the TIAA-CREF Mid Cap Value Fund posted only a slightly higher return of 0.71%, this was worth a ranking in the 12th percentile of Morningstar's mid-cap value universe.
- For the first time in a number of quarters, small cap stocks underperformed large cap stocks. With valuations getting a little stretched within small caps, it was likely a little overdue. Of the two funds in the Plan, the T. Rowe Price Growth Fund had the stronger showing, returning 1.57%. This ranked the fund in the 23rd percentile of the Morningstar small growth category. The fund benefited from technology related names in software services, as well as biotechnology positions. As mentioned previously, growth stocks outperformed value stocks during the quarter, and the small cap space was no different. The Columbia Small Cap Value Fund returned -1.99%, and ranked in the 47th percentile of the Morningstar small value fund universe. Highlights from the consumer sector drove returns for the fund during the quarter including GNC Holdings (+30.2%), Domino's Pizza (+37.0%), and Helen of Troy (+17.4%). The fund managers, in their quarterly commentary, indicated a desire to maintain overweights vs. the Russell 2000 Index in a number of economically-sensitive sectors, including technology, consumer discretionary, and industrials.

DISCUSSION HIGHLIGHTS

- REITs were once again the leading asset class in the Plan for the quarter, returning 3.88% as measured by the DJ Wilshire REIT Index. Our fund, the Nuveen Real Estate Equity Fund was basically in-line with this return, posting a 3.71% return. Supporting returns for the quarter were holdings in their top 10: Boston Properties +11.9%, Simon Property Group +8.5%, Macerich +8.0%, Avalonbay +6.9% and Vornado Realty Trust 6.5%. Year to date, the fund is up 10.4%. Real estate has been supported by continued improvement in the fundamentals. Rents are improving, buildings are beginning to trade, and there has been some improvement in new developments. An expanding global economy does bode well for this sector, and so far the macro-oriented events such as the Middle East, Japanese earthquake/tsunami, and the sovereign debt crisis has not impacted this sector. Peripheral dynamics such as individual investors seeking yield, in a yield-starved environment, as well as private equity potentially looking to put money to work into properties also have supported performance in this asset class.
- Emerging markets still appear attractive to us due to the combination of attractive earnings growth, strong governmental balance sheets, and valuations on a price/earnings basis that are priced at 10.5X on a forward earnings basis. The challenge has been that various emerging markets are trying to engineer a “soft landing” type of scenario, raising interest rates to slightly slow their growth rates, while temper inflationary pressures. Our emerging market fund the RS Emerging Markets Fund was off -2.82%. During the quarter, the bell-weather emerging market “BRIC” nations struggled: Brazil -4.1%, Russia -5.6%, India -3.6%, and China -1.9%. While it was a difficult quarter, it is our inclination to maintain our current 2.5% allocation to emerging markets.
- Developed international markets were mixed in the second quarter. Developed markets, as measured by the MSCI-EAFE Index were up 1.57% during the quarter. We continue to maintain our underweight position in international equities as we are concerned about the sovereign debt situation in Europe. Greece, and towards the end of the quarter, Italy weighed on international market returns. While the Dodge and Cox International Stock Fund lagged the benchmark during the quarter (+0.46%), both the MFS International Growth Fund (+3.63%) and the HighMark International Opportunity Fund (+2.31%) had solid quarters.
- Within global equities, the Templeton Global Opportunities Fund returned 1.12%, outperforming the MSCI-ACWI Index (+.24%). From a geographic standpoint, investments in Continental Europe supported performance, as well as North American equity exposure. In regards to sector exposure, while the fund’s holdings in healthcare had been a drag on performance throughout previous quarters, this quarter the fund was rewarded for their patience as healthcare was the single most positive sector towards performance. The fund’s contrarian bent also saw it seek to slightly increase their financial holdings – although the fund still is underweight relative to the benchmark. The managers, in their quarterly commentary suggest that the growing debt burdens within countries, rising interest rates, creeping inflationary pressures and political discord is impacting most regions of the world. However, in this environment the managers believe that opportunities will emerge for potential attractive investments. In the second quarter the fund ranked in the 41st percentile of the Morningstar World Stock universe.

DISCUSSION HIGHLIGHTS

- The Barclays Aggregate Bond Index gained 2.3% in the second quarter as investment-grade corporate bonds, agency mortgage-backed securities and U.S. Treasuries posted positive returns. The quarter was generally characterized by a return to quality, or the “risk off” trade, as lower quality and more cyclical names underperformed while Treasuries and higher quality names performed well. As of June 30, 2011, the Federal Reserve completed its \$600 billion Treasury purchase program, marking the end of an eight month program of Treasury purchases intended to keep interest rates low and stimulate economic activity. In addition to approximately \$1.5 trillion Treasury securities, the Federal Reserve continues to hold over \$900 billion worth of mortgage-backed securities acquired during the initial quantitative easing program which ended in March 2010. Upon the completion of the Treasury purchase program in June, the Fed announced that it would continue to reinvest the principal payments from all domestic securities into additional Treasury securities in order to maintain the total face value of its securities holdings at approximately \$2.6 trillion. In the absence of this reinvestment activity the Federal Reserve would be implicitly tightening monetary policy, which they want to avoid until they believe the economy has reached a self-sustaining recovery.
- Weaker economic data and the ongoing European debt crisis led to a 2.4% gain in the U.S. Treasury index this quarter, as ten-year Treasury yields declined 31 basis points and thirty-year bond yields fell 14 basis points. Investment-grade corporate bonds returned 2.3% for the quarter, underperforming equal-duration Treasuries by -32 basis points, as spreads widened +14 basis points. Mortgage-backed securities outperformed equal-duration Treasuries by +35 basis points this quarter, with a return of 2.3%.
- The individual fixed income holdings outperformed the Barclays Aggregate index during the second quarter with a return of 2.4% versus 2.3% for the index. Although we maintained a shorter duration than the benchmark during a quarter when rates declined, our advantageous yield curve positioning offset the impact from a short duration. The U.S. Treasury sector had the best performance this quarter, however, our underweight to Treasuries and overweight to corporate bonds was offset by the higher income from corporate bonds and positive security selection. A number of corporate bonds held in the Plan, such as Verizon, Comcast, Time Warner, AB InBev, and BP had total returns of 4% or more for the quarter.
- The Pimco Total Return Bond Fund returned 1.86%. The underperformance relative to the benchmark stems from several strategic moves. First, the fund maintained an underweight to U.S. Treasuries of 31% vs. the Barclays Aggregate Index. Second, the duration of the fund at the quarter end was 4.4 years (Barclay's Aggregate duration 5.2 years), but the average duration that the fund maintained over the course of the quarter was much lower. Finally, relative to the duration positioning, the fund was the 29% net cash equivalent position during the quarter. On the positive side for the fund was the 11% weight in emerging market debt. Emerging market debt had a strong quarter, up over 3.4%.
- The Pimco High Yield Fund returned 0.88% for the quarter, underperforming the Merrill Lynch U.S. High Yield BB-B Index return of 1.13%. On a relative basis, this performance was strong enough to place the fund in the 23rd percentile of Morningstar's High Yield Bond Universe.

INVESTMENT STRATEGY AS OF June 30, 2011

Tactical Asset Allocation

<u>Asset Class</u>	<u>% Portfolio Weighting</u>			<u>Rationale</u>
	Target	Current Portfolio	Over/Under Weighting	
Cash	1%	18%	17%	<ul style="list-style-type: none"> Large cash contribution of \$5.6 million (9% of Plan assets) at the end of the quarter is skewing cash position.
Fixed Income	45%	33%	(12%)	<ul style="list-style-type: none"> While cash contribution skews fixed income allocation position, we are strategically targeting a 5% underweight to fixed income. Lack of compelling valuation and expectations for an increase in interest rates in 2Q012 are driving the underweight position. Duration target is 90% of benchmark.
High Yield	0%	2%	2%	<ul style="list-style-type: none"> We are targeting a 3% allocation to high yield. Corporate default rates are low, spreads over treasuries are somewhat attractive, and in an environment of continued growth in the economy, high yield should do well.
Real Estate (REITS)	4%	4%	0%	<ul style="list-style-type: none"> With interest rates low, cash flows improving, and an up-tick in demand, prices for properties in the commercial REIT sector have improved. Apartment REITs are also benefiting due to the continued woes in the housing market. We are targeting a 1% overweight to real estate.

Tactical Asset Allocation

<u>Asset Class</u>	<u>% Portfolio Weighting</u>			<u>Rationale</u>
	Target	Current Portfolio	Over/Under Weighting	
Global Equity	8%	5.5%	(2.5%)	<ul style="list-style-type: none"> While similar challenges exist within global equities, that international equities face, we will seek to maintain at least an equal weight within this “go-anywhere” asset class.
International (Developed)	10%	4%	(6%)	<ul style="list-style-type: none"> Sovereign debt issues in Western Europe, coupled with some spill over from a modest decline in growth from emerging market nations compel us to target a 2% underweight to international equities
International (Emerging)	0%	2.5%	2.5%	<ul style="list-style-type: none"> Currently targeting a 2.5% allocation to emerging markets. We are cautious regarding BRIC nations as some have raised their interest rates to both slow down growth rates and to fight inflationary forces.
Total Domestic Equity	32%	33%	1%	
Large Cap	18%	19%	1%	<ul style="list-style-type: none"> We are targeting a 3% overweight to large cap equities. Valuations are attractive with a forward PE ratio of between 12-13X. We maintain a slight value tilt
Mid Cap	6%	7%	1%	<ul style="list-style-type: none"> We maintain a modest overweight with mid-caps as we see growth rates attractive, and valuations reasonable for this asset class.

Tactical Asset Allocation

<u>Asset Class</u>	<u>% Portfolio Weighting</u>			<u>Rationale</u>
	Target	Current Portfolio	Over/Under Weighting	
Small Cap	8%	7%	(1%)	<ul style="list-style-type: none">■ We look to maintain a slight underweight of 1% to small cap equities. Valuations are getting a little expensive with a forward PE ratio of 17X earnings.

ASSET ALLOCATION

Asset Allocation	3/31/2011 Market Value	3/31/2011 % of Total	6/30/2011 Market Value	6/30/2011 % of Total	Target Allocation
Domestic Equity					
Large Cap Core Holdings	\$ 3,312,220	6.5%	\$ 6,271,790	10.1%	-
T. Rowe Price Equity Income Fund	1,637,562	3.2%	\$ 2,488,235	4.0%	-
Loomis Sayles Value Fund	-	-	\$ 781,772	1.3%	-
Harbor Capital Appreciation Instl	549,443	1.1%	\$ 1,138,415	1.8%	-
T. Rowe Price Growth Stock Fund	548,939	1.1%	\$ 1,130,186	1.8%	-
TIAA-CREF Mid-Cap Value Instl	1,248,351	2.4%	\$ 2,452,191	3.9%	-
HighMark Geneva Mid Cap Growth Fund	1,154,557	2.3%	\$ 1,800,084	2.9%	-
Columbia Small Cap Value Fund II	1,581,587	3.1%	\$ 2,457,719	4.0%	-
T. Rowe Price New Horizons Fund	1,134,414	2.2%	\$ 1,929,657	3.1%	-
Total Domestic Equity	\$ 11,167,073	21.8%	\$ 20,450,048	32.9% <i>Range</i>	32.0% <i>21-57%</i>
International					
HighMark International Opportunity Fund	701,904	1.4%	\$ 852,154	1.4%	-
Dodge & Cox International Stock Fund	522,119	1.0%	\$ 857,112	1.4%	-
MFS International Growth Fund	528,599	1.0%	\$ 850,309	1.4%	-
RS Emerging Markets Y	958,507	1.9%	\$ 1,531,402	2.5%	-
Total International	\$ 2,711,128	5.3%	\$ 4,090,977	6.6% <i>Range</i>	10.0% <i>4-19%</i>
Global					
Templeton Global Opportunities A LW	1,164,252	2.3%	\$ 3,455,269	5.6%	-
Total Real Estate	\$ 1,164,252	2.3%	\$ 3,455,269	5.6% <i>Range</i>	8.0% <i>4-12%</i>
Real Estate					
Nuveen Real Estate Secs I Fund	1,240,437	2.4%	\$ 2,579,657	4.1%	-
Total Real Estate	\$ 1,240,437	2.4%	\$ 2,579,657	4.1% <i>Range</i>	4.0% <i>0-8%</i>
Fixed Income					
Core Fixed Income Holdings	\$ 6,247,579	12.2%	\$ 14,961,474	24.1%	-
PIMCO Total Return Instl Fund	2,637,212	5.1%	\$ 4,517,142	7.3%	-
PIMCO High Yield Instl	998,013	1.9%	\$ 1,117,014	1.8%	-
Total Fixed Income	\$ 9,882,804	19.3%	\$ 20,595,629	33.1% <i>Range</i>	45.0% <i>35-67%</i>
Cash					
HighMark Diversified MM Fund	\$ 25,101,777	49.0%	\$ 10,997,465	17.7%	-
Total Cash	\$ 25,101,777	49.0%	\$ 10,997,465	17.7% <i>Range</i>	1.0% <i>0-5%</i>
TOTAL	\$ 51,267,470	100.0%	\$ 62,169,045	100.0%	100.0%

INVESTMENT RETURNS: Equities and Fixed Income

As of Second Quarter 2011

Investment Returns: Equities and Fixed Income	3 Months	Inception 5 Months*
Cash Equivalents	.01	.01
<i>iMoneyNet Taxable</i>	.00	.00
Fixed Holdings	2.17	3.10
<i>Barclays Aggregate Bond Index</i>	2.30	2.62
Equity Holdings		
Domestic Common Stocks	-1.41	-1.37
<i>Russell 1000 Index</i>	.12	3.88
Large Cap Holdings	.31	-.49
<i>Russell 1000 Index</i>	.12	3.88
Mid Cap Holdings	.89	3.37
<i>Russell Mid Cap Index</i>	.41	5.82
Small Cap Holdings	-.42	3.77
<i>Russell 2000 Index</i>	-1.61	6.47
International Holdings	.22	2.64
<i>MSCI EAFE Index (Net)</i>	1.57	2.57
Global Equity Holdings	1.12	2.27
<i>MSCI AC World Index (Net)</i>	.24	3.06
Real Estate Holdings	3.89	4.76
<i>Wilshire REIT Index</i>	3.88	7.09
Annualized Investment Returns	3 Months	Inception 5 Months
Total Portfolio	.63	1.18
Total Portfolio (net of fees)	.60	1.15
<i>County of Contra Costa Benchmark**</i>	1.36	3.61

June 30, 2011

PARS: County of Contra Costa

*Inception Date: 02/01/201

**Benchmark: 18% Russell 1000 Index, 6% Russell Midcap Index, 8% Russell 2000 Index, 8% MSCI AC World ex US Index, 10% MSCI EAFE Index, 45% Barclays Aggregate Index, 4% DJ Wilshire REIT Index, 1% Citigroup 3 Month T-Bill Index.

Returns are gross-of-fees unless otherwise noted. Returns for periods over one year are annualized. The information presented has been obtained from sources believed to be accurate and reliable. Past performance is not indicative of future returns. Securities are not FDIC insured, have no bank guarantee, and may lose value.

PARS/COUNTY OF CONTRA COSTA PRHCP

For Periods Ending June 30, 2011

LARGE CAP EQUITY FUNDS							
Fund Name	1-Month Return	3-Month Return	Year-to-Date	1-Year Return	3-Year Return	5-Year Return	10-Year Return
T. Rowe Price Equity Income (1)	-1.86	-0.95	4.65	27.78	3.98	2.64	4.50
Loomis Sayles Value (2)	-1.80	-1.06	5.80	30.00	2.18	3.13	5.01
Harbor Capital Appreciation Instl	-0.25	3.64	8.44	35.45	5.85	5.73	2.78
T. Rowe Price Growth Stock	-1.31	0.06	5.26	33.77	4.19	4.91	4.01
Russell 1000 TR USD	-1.75	0.12	6.37	31.95	3.68	3.30	3.21
MID CAP EQUITY FUNDS							
HighMark Geneva Mid Cap Growth	-1.12	0.63	7.55	41.14	8.69	6.88	7.65
TIAA-Cref Mid-Cap Value Instl	-1.92	0.71	7.80	37.69	5.46	5.05	--
Russell Mid Cap TR USD	-2.09	0.41	8.08	38.49	6.46	5.30	7.59
SMALL CAP EQUITY FUNDS							
Columbia Small Cap Value II Z	-2.70	-1.99	7.56	40.37	6.86	4.31	--
T. Rowe Price New Horizons	-0.79	1.57	11.97	51.21	14.18	8.28	7.88
Russell 2000 Index	-2.31	-1.61	6.20	37.40	7.77	4.08	6.27
INTERNATIONAL EQUITY FUNDS							
Dodge & Cox Intl Stock	-2.13	0.46	3.00	31.37	1.34	3.43	9.72
HighMark Int'l Opportunities Fid	-1.69	2.31	5.01	33.10	-2.16	2.83	7.71
RS Emerging Markets Y	-1.78	-2.82	-3.21	22.89	3.96	11.68	16.82
MFS International Growth I	-1.53	3.63	4.81	32.78	3.29	6.11	8.48
MSCI EAFE Index	-1.25	1.57	4.99	30.39	-1.77	1.48	5.66
Templeton Global Opportunities A LW	-2.12	1.12	7.00	29.19	-0.26	3.64	5.76
MSCI AC World NR USD	-1.58	0.24	4.67	30.12	0.91	3.14	4.78
REIT EQUITY FUNDS							
Nuveen Real Estate Secs I	-3.13	3.71	10.36	35.47	7.92	4.60	12.85
Wilshire REIT Index	-3.35	3.88	10.86	35.55	4.89	1.00	10.18
BOND FUNDS							
Pimco Total Return Inst'l	-0.36	1.86	2.99	5.93	9.46	8.87	7.38
BarCap US Aggregate Bond	-0.29	2.30	2.74	3.94	6.47	6.53	5.75
PIMCO High Yield Instl	-0.97	0.88	4.29	13.85	10.04	7.90	7.87
Merrill Lynch US High Yield BB-B Index	-0.87	1.13	4.81	14.72	10.50	8.23	7.86

Source: SEI Investments, Morningstar Investments

(1) Fund was added to the Plan in March 2011

(2) Fund was added to the Plan in June 2011

Returns less than one year are not annualized. Past performance is no indication of future results. The information presented has been obtained from sources believed to be accurate and reliable. Securities are not FDIC insured, have no bank guarantee and may lose value.

OUR DEMISE IS GREATLY EXAGGERATED

Are America's best days in the past? We live in an age of tremendous innovation and opportunity that shows no signs of slowing, which has fundamentally lifted our living standards over the last century. As a nation, we are always enamored with *new things* and hot trends. Innovation also has ushered in more complexity than ever before. Workers have to be more adaptable to the changing needs of employers, while there remains a nagging sense of anxiety about the future that has cast a long dark shadow over the U.S. economy. We think such fears are fueled by an unlucky period of exogenous events and a few policy-driven headwinds, many of which are moderating now---not a secular *New Normal*. Our needs can be met if there are plentiful jobs, abundant risk capital, and gains in productivity. We think that with devotion to our nation's free market principles, companies will be motivated to make innovation routine, and that *Our Demise Is Greatly Exaggerated*.

The technology boom of the 1990s has given way to exciting innovations in many other fields, from biological sciences to materials engineering and energy. Specialization regularly challenges our understanding of utility and significance. Distinctive innovations can offer a marketing edge, counter a competitive threat, open up a new market, provide cost advantage or reveal a previously unknown need. Innovation and technology have even been blamed by some for job losses during the recession, while investors grapple with the uncertainty of what will drive our economy forward in the next decade. Can we hope to anticipate the future when we struggle ever more to understand discoveries that present new opportunities?

Over the last decade, we've highlighted emerging market growth and secular disinflation as themes that boosted productivity and earnings growth beyond expectations. New markets for U.S. companies provided significant expansion opportunities, but as emerging and frontier economies mature, their growth will eventually slow. Thus, it isn't as obvious how we can maintain the global growth we've enjoyed over the last decade. Should we simply expect progress to stall? We think such fears are fueled by an unlucky period of coincident cyclical headwinds, not a secular *New Normal*. Lately, our society seems inclined to reinforce self-pity and a sense of entitlement, but we're reminded of the words of DH Lawrence: "*I never saw a wild thing sorry for itself.*" Competitive U.S. companies are hardly standing still,

evidenced by strong earnings growth and pipelines of new products. Companies that took advantage of the crisis to increase market share, acquire top talent or invest in their business exploited available opportunities that are paying dividends today. We believe our future remains bright and full of opportunities, therefore *Our Demise Is Greatly Exaggerated*.

Investment Performance Review

The S&P 500 just barely chalked up its seventh positive quarter in a row through June 2011, returning 0.1%. The S&P 500 Index has returned over 107% since the intraday lows on March 6, 2009, which is just -7.5% shy of the October 2007 month-end high. For 2011, the S&P 500 has returned 6.0%, outperforming both developed international equity (MSCI EAFE: 5.4%) and MSCI Emerging Market Index (1.0%). Japan's TOPIX returned -3.9% on the heels of the devastating earthquake, but many European countries posted even weaker returns given uncertainty over the sovereign debt crisis. If not for a weak U.S. dollar (-3.8%), U.S. equities would have outperformed by a wider margin. Barclays Capital Aggregate Bond Index returned 2.3% and high-yield bonds (1.0%) added to strong year-to-date performance.

Growth stocks outpaced value stocks by 0.9%, according to Russell indices, while small-cap stocks edged out large-cap stocks by 0.2% in 2011 through the second quarter. We observed significant dispersion in sector returns during the quarter. Financials (-5.9%) and Energy (-4.6%) lagged, while more defensive sectors, including Health Care (+7.9%) and Utilities (+6.1%) fared much better. REITs (+2.9%) returned 10.6% in 2011.

Global Economic Outlook

Recent economic data in April-June raised doubts among consumers and investors about whether the expansion is sustainable, while inflation has ratcheted higher. Weak job growth and limited housing starts remain the two most visible concerns. We believe that in contrast to similar "Dr. Evil"¹ comparable weakness observed from April-August 2010, the recent slowdown of "Mini Me" proportion is likely to be resolved more quickly and have less significant impact, because it began from a less fragile economic state. So, is it really as bad as it seems? Over the last year, retail sales

¹ Villainous fictional character in the *Austin Powers* film series. Mini Me was Dr. Evil's side-kick and dwarf clone of himself.

exceeded 9.5%, industrial production rose 5.8%, and export growth climbed 20%. Many other indicators also suggest the U.S. economy is remarkably resilient. Most economists still expect a stronger second half for 2011, as transitional second quarter headwinds already appear to be moderating.

Several specific unfavorable forces have undermined business and consumer confidence. These forces include: (1) Supply chain disruptions in technology and automobile manufacturing from the Japanese earthquake, (2) Monetary policy tightening in emerging market economies, particularly China, Brazil, and India, (3) Higher oil prices coupled with destabilized Middle Eastern and North African governments resulting from the Arab Spring uprisings, (4) Risk of contagion from the European debt crisis and (5) Financial reform uncertainty in finalizing Dodd-Frank regulations, and resolving Basel III capital requirements, (6) Unusual weather effects, including tornados, flooding and wildfires in drought regions. It is not surprising these mostly exogenous and transitory forces have increased investor uncertainty and contributed to slowing economic growth.

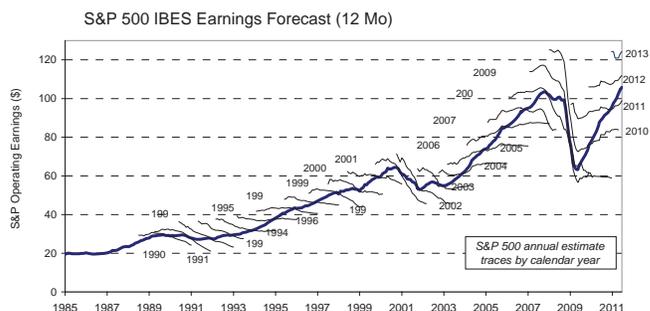
The U.S. has confronted many challenges that have undermined business and consumer confidence. Over two years since tackling the devastating Financial Crisis, the U.S. economy has rebounded. The NASDAQ and S&P 500 have surpassed 2008 pre-crash levels and are approaching new highs, bolstered by improving economic conditions and strong earnings. Concerns still linger about high unemployment, housing weakness, and the eventual impact of unwinding loose monetary policy, but financial markets have responded favorably, with many economic indicators rising to previous highs or higher. Our identified five exceptional growth drivers, with the exception of housing starts, contributed to the performance of these growth metrics. Forecasts below suggest stable growth and strong earnings through 2013. An extended expansion is likely if inflation remains contained, but interest rate hikes are needed before inflation becomes entrenched.

Economic Forecasts	2008	2009	2010	2011e	2012e	2013e
U.S. GDP (Y/Y Real)	-1.9	0.2	2.8	2.8	3.0	3.0
Earnings Growth	-23.1	-7.1	40.3	12.5	10.4	13.2
CPI Inflation (Y/Y)	-0.1	2.8	1.4	2.5	2.5	2.5
Unemployment	7.3	9.9	9.4	8.5	8.0	7.3
Fed Funds Target	0.25	0.25	0.25	0.25	2.25	2.50
Treasury Notes-10y	2.25	3.84	3.31	3.55	4.13	4.50
S&P 500 Target	903.	1115.	1258.	1400.	1520.	1700.

Source: HighMark Capital estimates and Thomson Datastream

Optimistic S&P 500 earnings expectations continue to be revised higher for 2011-13. The S&P 500 Price/Earnings is trading just over 13X for 2011 and 11.7X for 2012 earnings expectations. Over the last eight quarters, earnings have beaten expectations by an impressive margin. Last quarter, 68% of companies beat January 1st estimates by 6.4%. Early results suggest Q2/2011 earnings will surprise positively again, as companies continue to benefit from an impressively persistent 9% net income margin. Positive earnings revisions, indicated below by rising estimates (annual squiggle lines),

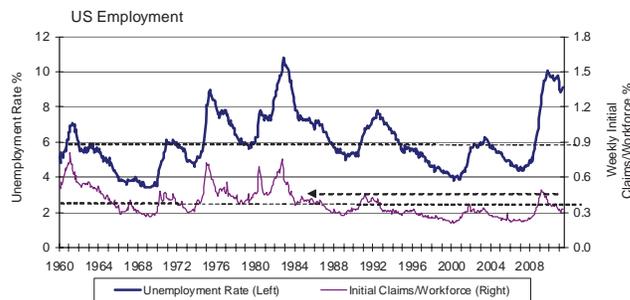
suggest increasing earnings confidence and visibility. Dividend growth has boosted payouts, which are still exceeding cash yields by an unusually wide margin. Strong earnings should continue to promote investment, innovation, higher incomes, and employment growth.



Earnings	2013e	2012e	2011e	2010	2009	2008
HighMark	14.3%	9.4%	12.5%	40.3%	-7.1%	-23.1%
Consensus	11.5%	13.4%	16.2%	40.3%	-7.1%	-23.1%
HighMark	\$ 120.00	\$ 105.00	\$ 96.00	\$ 85.32	\$ 60.80	\$ 65.47
Consensus	\$ 125.34	\$ 112.41	\$ 99.17	\$ 85.32	\$ 60.80	\$ 65.47
Financials	18.0%	24.0%	25.7%	288.2%	106.9%	-130.8%
Non-Financials	9.4%	11.3%	15.6%	28.1%	-18.6%	7.2%

Source: HighMark Capital estimates and Thomson Datastream

Employment growth is unusually weak for the high level of profit margins and strong cash flow growth observed. An unemployment rate that is over 6% tends to fall precipitously once trending in the right direction, as seen below. Monster.com job vacancies have been increasing at a 21% annualized pace over the last six months, suggesting something unusual must be impeding hiring, besides simply the availability of jobs. Initial claims for unemployment around 400,000, is encouraging when normalized for the size of the workforce. A decline in this indicator generally leads the unemployment rate lower.



Source: HighMark Capital and Thomson Datastream

To answer the question about what is unusual that could be impeding hiring, we've turned to recent Nobel Prize winning work by Peter Diamond, Dale Mortensen, and Christopher Pissarides on markets where buyers and sellers have difficulty finding each other. Intuitively, the mismatch in workers' skills with available jobs combined with job seeker disincentives, including unemployment benefits twice the previous maximum observed in 1982, could have boosted structural unemployment over the last two years. Costly unemployment benefits for up to two years seem to have actually impeded job growth. While job seeker disincentives are rapidly winding down now, rising costs of hiring employees due to health care

reform could be having undesirable consequences. Unusual factors seem to be resulting in elevated unemployment, but we expect employment to normalize.

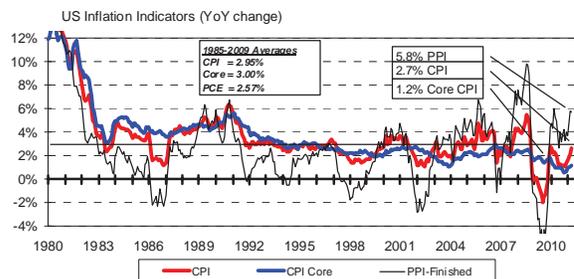
Employment is an acknowledged lagging indicator, but is monitored closely by the Federal Reserve. With U.S. elections in just 16 months, it is one of the most visible data points to voters. Concern about sluggish job growth has focused attention on business surveys that highlight the expected cost of health care and financial reform. Cash for Clunkers and the homebuyers' tax credit only pulled forward demand, creating more economic volatility and greater uncertainty. CBS News/New York Times polling in late June suggests just 28% of voters believe the country is headed in the right direction. In the meantime, other than budget-related issues, any major legislation is unlikely.

The American Recovery and Reinvestment Act (ARRA), passed in February 2009, was expected to increase U.S. debt by \$787 billion, but the estimated cost has risen to \$862 billion. ARRA provided no-where near the multiple of income benefit² that business loans, investment incentives or tax rate cuts might have provided. Academic studies suggest that no amount of temporary government spending will ever induce behavioral changes needed to lift an economy from a steep recession. President Obama recently remarked, "Shovel-ready was not as shovel ready as we expected." ARRA funding for states mostly filled a revenue shortfall, thus afforded little additional demand. Inadequate fraud monitoring, inefficient spending and other unintended consequences undermined any benefit due to the rush to get something done, in our opinion.

Compared to April 2009, about one million fewer jobs exist today. New jobs attributable to ARRA are difficult to identify, and much fewer than hoped. Employment has increased by only 1.2 million since job creation turned positive in October 2010. Even if we accept White House estimates that 2.4 million jobs have been saved or created by ARRA, then theoretically each job cost taxpayers \$359,000. Many economists now believe that ARRA provided little benefit to economic growth, so winding it down shouldn't have much impact either.

We are concerned about increasing prices for commodities, food, transportation, imports, and rent that have worked their way into prices of consumer goods and services. Weekly wages are also increasing with inflation. Wholesale, intermediate, and finished producer prices increasing 5.6-8.9% tend to lead consumer prices higher. Consumer price (CPI) inflation of 3.4% is already increasing faster than our upward revised 2.5% forecast for 2011. University of Michigan inflation expectations have increased to 4.4%, even if the Federal Reserve believes inflation expectations are well-anchored. Shelter costs, representing 32% of CPI, helped keep inflation low, but rent increases are boosting inflation.

We think that investors and the Federal Reserve should be more concerned about inflation.



Source: HighMark Capital and Thomson Datastream

Inflation concerns have led to increasing interest rates and tightening monetary policy in Australia, Norway, and many emerging market countries. The ECB hiked interest rates twice to 1.5%, so U.S. monetary policy should begin to tighten. Hiking rates from exceptionally low levels probably won't have much impact until real interest rates turn positive. We think interest rates will need to rise above 1.5-2.0% to have much impact. As rising inflation has become an increasing global threat, U.S. monetary policy should begin to tighten by winding down quantitative easing and hiking interest rates.

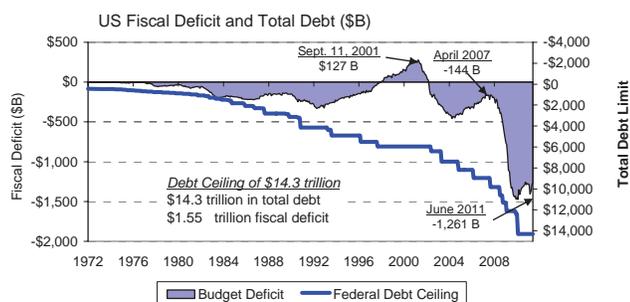
Fiscal Deficits & Spending

It is remarkable that so many developed economies are grappling with such significant debt burdens, from Europe to Japan, and the United States. The Financial Crisis took a significant toll on tax revenues globally. After application of Keynesian theories provided many decades of poor economic performance, it fell out of favor beginning in the 1970s, only to be resurrected for one last try in ARRA. Hope that government spending might kick-start an economic recovery failed to materialize---the evidence suggests for every \$1 spent or invested, less than \$1 of income was realized. ARRA was further doomed by imposing burdensome reform legislation and new regulations that added additional economic hurdles. We can't think of an instance that government-directed spending stimulus has prevailed globally. Performance of ARRA contrasts sharply with experiences in 1982 and post-9/11/2001 when tax cuts ignited self-reinforcing economic recoveries without taxpayer-funded spending.

Congressional Budget Office fiscal deficit estimates for FY2011 of \$1.55 trillion, or 10.6% of GDP, and FY2012 of \$1.19 trillion, suggest the need for reduced government spending and improved productivity, as the private sector has so effectively done. Since the 2007 transition in Congressional leadership, the fiscal deficit has increased ten-fold from \$144 billion, as spending rose 7.9% annually. Higher Treasury yields and a weaker U.S. dollar can be expected if Congress is unable to reduce the fiscal deficit. Lately the rating agencies have been ever more pre-emptive about downgrading issuers whose perceived default risk is increasing. An overreaction to the criticism of rating agencies for their belated response to deteriorating

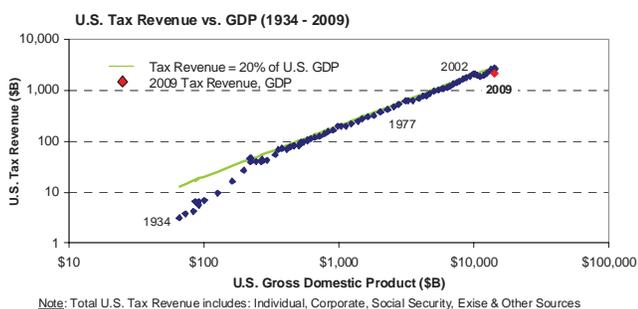
² Keynesian Multiplier = National Income / Spending

credit conditions in 2008 is not surprising. For now, we observe no evidence that Treasury yields are higher to compensate for increased risk that the U.S. Government will be downgraded or default.



Source: HighMark Capital and Thomson Datastream

We have written about Hauser's Law, which observes that total federal income and corporate tax revenue has never exceeded 20% of GDP since the income tax was introduced in 1913, regardless of wide fluctuations in corporate and individual tax rates of as high as 90%. Government spending has increased from 18% in 2001 to 25% recently, as a share of GDP. Spending increased 7% per year over 10 years. Raising tax rates only slows growth, maintaining the 20% relationship observed. The previous spending peak topped 23% in 1982, just before President Reagan proposed slashing income tax rates, which set-off the longest recorded U.S. expansion. Revenues remained about 20% of GDP, but both GDP and tax revenues surged. The only alternative now is for U.S. Government spending to be reduced below 20% of GDP. The private sector has shown that there are ways to increase productivity, in ways the government has yet to try to emulate. Economic growth has always been the most important driver of tax revenue.



Source: HighMark Capital and Congressional Budget Office

A few illustrations can help us appreciate the impact of proposals to reduce the U.S. fiscal deficit. For every \$1 trillion of debt over 10 years, an increase in borrowing rates from the current Treasury rate of 3% to the 6% historical average yield would cost \$400 billion. In the debate over raising the debt ceiling, slashing \$2 trillion in debt over 10 years would amount to reducing the budget deficit by \$158 billion a year or about 1% of GDP based on a 5% Treasury yield. What sounds like a heroic leap, is actually not that significant over a 10 year budget cycle, but it is progress. Even doubling the goal to \$4 trillion hardly slows spending, compared to our fiscal deficit of over \$1 trillion. In 2007, the year the Democrats

took control of the House and the Senate, the fiscal deficit was less than \$150 billion and falling.

U.S. households and corporations are among the most highly-taxed in the world, while having to navigate an extremely inefficient and complex tax code. Collection and compliance costs upwards of 30% of tax revenue, according to academic work highlighted last quarter. Meanwhile, increasingly progressive tax rates have resulted in the top 10% of wage earners paying 54.6% of federal income taxes, according to the Urban-Brookings Tax Policy Center. With a fewer number of households providing an ever greater share of IRS collections, tax revenues can't keep up with spending growth, while becoming more volatile and unpredictable. We believe tax reform and spending cuts are necessary to close the fiscal deficit, not higher tax rates, in our opinion. Lower tax rates have tended to drive higher economic growth, thereby boosting tax revenue, just as we've seen that higher tax rates slow growth, undermining tax revenues.

Unless we get our fiscal deficit under control, the U.S. government risks being downgraded and investors could demand a higher risk premium in the form of higher interest rates. Three primary credit rating agencies, Moody's, Fitch and S&P, have placed the Aaa/AAA/AAA credit rating of U.S. government on watch for possible downgrade as the default risk increased with the debt ceiling hanging in the balance. Almost half of all U.S. money market assets, or \$1.3 trillion of the total \$2.7 trillion total, are held in U.S. Treasuries. Ratings on securities for regulatory purposes are determined by averaging the highest two published ratings, so a rating agency's downgrade alone is a significant concern, but not as devastating as when two rating agencies both downgrade an issuer. It is hard to speculate how and when an individual rating agency might change their rating on the U.S. government, and one can only guess how capital markets will respond.

From a currency perspective, taking into account relative valuation, trade, growth, inflation, interest rates and investment flows, only interest rate differentials give us pause with respect to favoring the U.S. dollar over the Euro, Yen, and Sterling. Australian and Canadian dollars appear to be stretched, as well, according to our tactical asset allocation models. There is no other reasonable alternative to the U.S. dollar as the world's dominant reserve currency, in our opinion.

Raising the Debt Ceiling

We believe a U.S. Government default is unlikely at this time because we have the flexibility of many alternatives, while the consequences would be severe to the economy and financial markets for years to come. Equity investors have suffered the brunt of increasing risk aversion, while Treasuries rallied (yields fell) after the U.S. credit watch announcement. Treasury 10-year yields of 3.15% aren't discounting any likelihood of U.S. Government downgrade or default, in our opinion. Deal or no deal, the bond market seems unresponsive, but

equities are more volatile on any news. While distracting for investors, there should be no long-term economic impact once a compromise is secured, unless the debt ceiling becomes a recurring leverage point in budget negotiations. Congress failed to pass a budget resolution for FY 2011 until April 15th, over six months into the fiscal year, but another debate over the fiscal deficit will hinge on passing a budget for FY2012 by October 1st.

There is no theoretical limit to the amount the U.S. Government can borrow, only the constraint of a self-imposed debt ceiling, which is now maxed out. Raising the debt ceiling³ by Treasury's deadline of August 2nd has become tethered to House Republican efforts to cut spending, so we face some tough policy choices to cut spending, increase productivity of government functions, and reform tax policy. Failure to raise the debt limit won't necessarily result in default with interest payments just about 10% of tax revenue received on a monthly basis. Therefore, how to prioritize other ongoing liabilities are the most difficult decisions to make should Congress fail to raise the debt limit in time.

The Federal Reserve is holding \$1.6 trillion of U.S. Treasuries, or 11% of total Treasuries outstanding. The Federal Reserve is an agency of the U.S. Government, so Treasuries are simply liabilities it owes to itself. Cancelling some or all of this debt would be a convenient way to increase the debt ceiling, with no known economic consequence, except formally dishonoring the notion of the "full faith and credit of the U.S. government." Many believe we already crossed that line, particularly in the case of the most recent quantitative easing (QE-2). Cancelling Treasuries also addresses the question of how to reduce the Federal Reserve's balance sheet without sinking money supply down the road. If the Federal Reserve simply holds the debt to maturity, while refunding all interest to the U.S. Treasury, then what is the difference? The Federal Reserve refunded interest of about \$80 million in 2010.

Congressional approval isn't required to cancel Treasury debt. We think buying Treasuries worth \$600 billion in the latest quantitative easing was unnecessary and ineffective, but now provides an option that minimizes the likelihood of default. This idea might be easily dismissed, but a most likely critic of such an idea, Congressman Ron Paul, actually supports it as a member of the House Financial Services Committee. However, capital markets may exact a heavy risk premium the next time the Federal Reserve attempted quantitative easing, if Treasury did cancel the bonds. Furthermore, we believe there is no benefit to be realized by the Federal Reserve continuing to purchase additional Treasuries to replace maturing securities, so we expect this will be discontinued soon.

European Sovereign Debt Crisis

The European sovereign debt crisis is a grim reminder of the consequences of not living within our means. Many developed countries have reached a critical tipping point of accumulated debt that will be aggravated by the normalization of rising global interest rates. There exists no quick fix for the European debt crisis, but slowing government spending won't take much off global growth either. The potential for higher tax rates worry us most, with distressed countries locked into an overvalued Euro and high interest rates. Many roads lead to increased national prosperity, but all require the ability for governments to live within their means.

Greece, Portugal, and Ireland have been downgraded below investment grade, which limits many institutional investors from purchasing their debt. Elected politicians always find it is easier to bestow generous government subsidized benefits, rather than cut spending. With Debt/GDP of 144%, Greece is in a challenging position, and will be forced to privatize national assets, raise taxes, and make deep spending cuts, including reducing entitlements, to bring down its high debt level. Rolling over maturing debt has become prohibitively expensive, while high interest rates only undermine the deficit further. Social unrest and protests unfolding across Europe emphasize the need to address the politically difficult fiscal deficits sooner, before options are limited.

Failure to abide by the Maastricht Treaty has compromised the fiscal viability of Portugal, Greece, Ireland, Italy, and Spain. With failure of a government's economic policies, currency devaluation typically provides a mechanism to restore competitive advantage versus a country's trading partners. A fatal flaw of any heterogeneous monetary union is that there is no way out for failing countries that are relatively uncompetitive and pile up too much debt. Spain and Italy may have turned the corner, despite a recent spike in bond yields, but the fiscal viability of several countries in the Eurozone will hinge on credible path back to solvency. Despite lacking political union, if they remain committed to fiscal discipline and adopt effective economic policies, they should not suffer as Greece, Portugal, and Ireland.

Painful social unrest highlights the lessons to be learned from the difficult policy choices now imposed by the IMF and ECB, as conditions of financial support. Increasing tax rates, selling off state assets, rationalizing the government workforce, and unwinding unsustainable entitlements, are an unpalatable mix, leaving no one untouched. The Maastricht Treaty outlined certain commandments for members of the European Monetary Union (EMU), but provided little executive authority to impose or enforce fiscal discipline, beyond the ECB. Without political union within the EMU, we believe misguided legislative and regulatory mistakes at the country level has recklessly increased debt and introduced crippling inefficiencies that have impeded recovery across Europe. Any workout will take years and involve painful sacrifices without a weaker currency.

³ See "Raising the U.S. Debt Ceiling and Fiscal Budget Deficit Debate – Summary Thoughts", *Investment Insights*, July 2011.

The Maastricht Treaty never anticipated the exit of any nation from the European Monetary Union (EMU), suggesting only an individual country has the ability to decide how and when they might exit. Any nation wishing to abandon the Euro and leave the EMU can do so, probably by referendum. If heavily-indebted countries can't restructure their debt and recurring liabilities, either countries will no longer issue debt individually or Germany could leave EMU by referendum, because it can no longer subsidize other EMU members that choose not to abide by the treaty. More than a year has passed with no obvious lasting solution for the European debt crisis. We are surprised that the Euro has remained so resilient during this European debt crisis.

Some economists believe that the EMU is unsustainable without greater political integration. For now, Greece is unlikely to leave the Eurozone because no politician would ever survive such a transition and few Greek voters would elect to do so. On the other hand, we put higher odds that Germany would withdraw from the Eurozone, possibly triggering departures of Luxemburg and the Netherlands, as well. While seemingly a remote possibility, a German referendum reintroducing the Deutschemark would probably weaken the Euro toward parity with the U.S. dollar, but also provide a competitive currency advantage to Greece, Portugal, Ireland, Italy, and Spain that would help their economies recover. Improved competitiveness of a weaker Euro would bolster exports, thereby reducing fiscal deficits for the remaining euro-denominated countries. Head of Italy's Central Bank, Mario Draghi, will succeed Jean-Claude Trichet as the next President of the ECB in November 2011. The decision of Axel Weber, President of the Deutsche Bundesbank, not to seek the job of ECB President may have increased the odds of Germany leaving the EMU.

The ECB has limited options to deal with Greece, including: (1) some form of debt restructuring, or (2) the ECB becomes the sole issuer of Euro-denominated debt. Neither option addresses the real issue of putting Greece on a long-term fiscally sustainable path. Any attempt at further political integration within the monetary union has been rebuffed by national sovereign interests. It is unlikely that any heavily indebted country with rising interest rates would willfully leave the Eurozone cocoon, but Germany could choose to withdraw if the cost of membership becomes too great.

Should We Worry More About Japan?

We've highlighted the likely transitory consequences of the devastating Japanese earthquake in March. We anticipated weakening Japanese economic growth near-term, but are seeing signs of recovery and expect this to accelerate later this year. Component shortages and transportation bottlenecks have slowed manufacturing in Japan, but most unexpected were shortages observed in Japan-sourced automotive and technology components, affecting some U.S. assembly lines. Electricity capacity is still strained, resulting in continued production outages

and global supply chain disruptions. Alternative sourcing of parts likely will result in permanent market share losses. The recent pick-up, now being observed, should translate into better second half global growth, and should leverage an improving cyclical outlook for the global economy.

While Japan's growth should improve, our concerns begin with a strong Yen that could cap export competitiveness and include an overwhelming debt burden. Funding earthquake rebuilding costs, on top of aggressive government stimulus during the Financial Crisis, has increased debt substantially. In the absence of meaningful population growth in a rapidly aging country, an increasing need for greater external financing, and already high debt level leaves Japan vulnerable to exogenous events and economic distress.

From the CIA World Factbook, Japan's AA+ rated debt exceeds 225% of GDP and totals 22% more than the second largest debtor nation, the United States, albeit with 1/3rd our population and 1/3rd of U.S. GDP. Japan is the highest debtor by any metric among OECD countries, but interest rates are exceptionally low. Japan has avoided the scrutiny that Greece and Italy have received only because it finances over 90% of its debt internally. The largest share of nearly 40% is held by Japanese banks, including the state-owned Post Bank. Insurance companies hold about 20%, while pensions and the BOJ hold roughly 10% each. With foreign holdings of JGBs estimated to be 7-8%, Japan has little trouble rolling over maturities. Efforts to privatize the Post Bank would probably increase yields by diversifying investments away from government debt. If investors ever demand a higher risk premium on 10-year JGBs, now yielding 1.1%, we'd expect the Yen to weaken and bond yields to rise, increasing interest expense.

Global investors seem preoccupied with the Eurozone debt crisis and debate over raising the U.S. debt ceiling to pay much attention to Japan for now, but we think exposure to Japanese debt and an overvalued Yen are a potential downside risk. Japanese growth should improve, but a strong Yen caps export competitiveness. An overwhelming debt burden risks persistently higher interest rates. As Japan is the largest share of international bond benchmarks, international bond strategies could be compromised, in our opinion.

Excess Return in Forgotten Places

Some investors are missing out on an opportunity to add value in their portfolios. We think there is no more overlooked opportunity to add value in most investor portfolios than actively managing large-cap equity and core bond allocations. Large-cap equity and core bond holdings typically represent the largest share of most investors' balanced portfolios. Yet there is no evidence that it is easier to outperform an index in niche asset classes of publically traded securities, for example small-cap stocks, than it is in large-cap equity strategies. In fact, large-cap equity and core bond strategies hold

more liquid securities that are less expensive to manage and trade than securities in other asset classes. There are always plenty of large-cap stocks outperforming the market by a significant margin. A simple thought experiment can be marvelously illuminating. Is it better to add value of 1% to 40% of one's portfolio (40 basis points) or chase twice the gain of 2% value added, on just 10% (20 basis points)? Return dispersion tends to be greater in less efficient asset classes, but it isn't any easier to outperform.

Having fewer competitors in a investment strategy category doesn't make it any easier to outperform a benchmark, particularly with less liquidity, but higher transaction costs and management fees of more esoteric and higher risk strategies. It is certainly much harder to add twice as much value, even versus asset classes considered more efficient. Finally, the logic of index mutual funds with lower management expenses seems intuitive, but guaranteed underperformance compounded over decades (index return – management fees – trading costs < index return) is detrimental to wealth creation. One gets what one pays for simply going cheap, and most investors are overlooking a significant opportunity, focused on more exotic strategies with demanding expectations.

Preferences for active vs. passive management have swung back and forth over the last 30 years. If roughly 30% of large-cap core equity funds are passively managed, then even if 50% of active managers outperform, only 35% (= 50% x 70%) of all mutual funds would outperform their index--our observations are somewhat more favorable than that. Thus, is it insidious to suggest that passive investing is more cost effective? All passive funds must necessarily underperform their benchmarks over any longer period of time. We don't have to pick the best managers, just avoid the worst 25%, and a 50-50 chance of picking a good active manager improves. Picking a couple active managers across a greater share of a portfolio increases the potential outperformance, if any skill is present.

The ebb and flow of active manager effectiveness is often explained by the dispersion of returns observed. A higher percentage of active managers tend to outperform when smaller companies are outperforming. Similarly, active bond managers tend to outperform when Treasuries are lagging and they hold more credit exposure. When correlations are high, such as during the Financial Crisis, security selection becomes more difficult. Flocking to passive strategies is not uncommon when risk aversion increases, but the result is greater market inefficiency created by the herd-like behavior of passive index investors. These are times when active managers, lying-in-wait, can exploit passive investors. Behavioral inefficiencies apply to traditional liquid investments as much as esoteric asset classes. Thus, investors, seeking refuge by hunkering down passively, are ignoring the largest potential opportunity, at often the best time, to add value in their portfolio.

Conclusion

We believe there are many reasons why *Our Demise Is Greatly Exaggerated*. Understanding important variables and weighing possible outcomes helps us to understand what is most likely when the future seems so uncertain. In school, we are taught to follow the rules, including coloring within the lines. At HighMark, we acknowledge our predilection toward coloring outside the lines—some call us contrarians, but we invest with intuition and our eyes wide open, judging empirical data with creativity and the courage of our convictions. As macro-sector correlations retreat further, performance dispersions should increase, providing greater opportunity for active management. We believe managers, focused on the fundamentals, are best positioned to reap the value added benefits available.

Signs of lingering investor risk aversion suggest to us there can still be significant upside to global equities, supported by attractive valuations. Every time we turn a corner, another some other challenge appears on the horizon. While investor concerns are focused on growth, inflation is feeding into prices of goods and services. We should expect tighter fiscal and monetary policy, as well as the need to hike interest rates, reform tax policy, and issue a lot of Treasuries, without the buying support of the Federal Reserve. Thousands of regulations still to be finalized, resulting from passage of health care and financial reform. Our theme of global synchronized recovery is finally showing signs of maturity as national interests begin to diverge, while emerging market growth has become more cyclical. Higher inflation than expected, which drives up interest rates, is the most likely economic concern that could derail the expansion and robust profit margins in the foreseeable future. We don't dismiss any of these concerns, but we weigh them relative to many U.S. and global economic positives, which leads us to the conclusion that *Our Demise is Greatly Exaggerated*.

We shouldn't expect the European debt crisis will be easily resolved and the workout may take years, but we don't think expected government austerity in the Eurozone periphery will detract much from global growth. Contagion should be limited. Growth could be curtailed though for those distressed countries locked into a Euro that is too strong, combined with the specter of sustained higher interest rates and potential for substantially higher taxes. The European sovereign debt crisis provides ample forewarning to other nations with deteriorating fiscal deficits, while still enjoying ultra-low interest rates, at least for now. Social unrest and protests across Europe emphasize the need to address politically difficult decisions promptly across Europe, as well as other increasingly indebted countries.

The strong equity rally has been bolstered by improving economic conditions and strong earnings, although concerns linger about high unemployment, housing weakness, and the eventual unwinding of loose monetary policy. Financial markets have responded

positively, with many economic indicators at least *Getting Back to Even (2Q/2011 Outlook)*. The U.S. has confronted many challenges to investor confidence, but unlikely scenarios already seem to be discounted. Meanwhile, a recent survey of member firms from the National Association for Business Economics suggests that the U.S. economy is gaining strength, despite these many headwinds. Global fundamentals appear plenty resilient, so our economic outlook forecasts 2.8% GDP in 2011 and 3.0% growth after that through 2013. In the long-run, U.S. equities are positioned to benefit from many global secular trends without the distractions that have impeded competitiveness of Europe and Japan.

Every generation experiences some great fear, whether the Cold War of 1980s, lagging behind in 1990s, or terrorism in the 2000s. We suspect that Osama bin Laden's death and resulting intelligence haul, at the hands of the U.S. military, while hiding in the suburbs of Islamabad, will eventually be recognized as an important fear-defusing milestone. Will we then define the next decade by our fear of rolling fiscal crises, inflationary commodity prices or something else entirely? Protecting the economic incentives of our nation's founding principles that give life to our basic rights, freedoms, unrestricted capitalism and rule of law is vital. Overcoming our greatest fears often leads to the most meaningful discoveries that few ever envisioned.

We have been very specific about the fundamentals that we think drove the compelling case for U.S. equities over

the last two years. Much of our thesis remains intact that improving economic conditions and strong earnings growth should favor equities at the expense of bonds. Economic conditions continue to normalize, which should be reassuring to investors. Real bond yields are near historic lows with inflation ratcheting higher, providing no valuation support for fixed income investors. The Federal Reserve won't hold rates at exceptional lows forever, so the question is not if, but when will interest rates rise. With so many other central banks already raising interest rates, we expect successive 25 basis point increases to begin in Q1/2012. On the other hand, equity valuations were compelling in March 2009, yet they have only improved. U.S. demand for goods and services has rebounded, productivity rose, and earnings soared. Global equity markets are cheaper now than a year ago, while a favorable economic outlook is more assured, so *Our Demise Is Greatly Exaggerated*.

We remain overweight global equities, with a preference for U.S. stocks vs. international developed markets, and an underweight to bonds, particularly Treasuries. We think commodity prices are stretched and due for a correction. Recently, we re-engaged with Emerging Market equities, shifting to an overweight after the recent pullback. We also boosted our allocation to high-yield bonds since we pushed out our first hike in interest rates to Q1/2012.

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