MEMORANDUM

TO: Deferred Compensation Board Members and Staff
FROM: Jon Traver
DATE: May 25, 2004

I tried to summarize below, in more detail, the reasons for raising the issue of the Board recommending individual active managed mutual funds to Deferred Comp participants. I have drawn heavily on John Bogle's (Vanguard) book, Common Sense on Mutual Funds, and Charles Ellis' (Yale University) book, Winning the Loser's Game mixed with my own investment experience as an individual and at the State of Wisconsin Investment Board. There is also a website called fundadvice.com that has a good article called "The Ultimate Buy-and-Hold Strategy which has good information about what I'm suggesting, and it's free. I welcome questions or challenges to anything I've said in the last memo or below.

Background

1. The S&P 500 Index outperformed 79% of all managers of equity mutual funds that survived the period from 1978-1998. (Bogle)
2. Institutional investors have underperformed the return of the S&P 500 because the costs of institutional investing have consumed 20 percent of the returns earned by the managers, causing the transformation that took money management from a Winner's Game to a Loser's Game. (Ellis)
3. The success that indexing has enjoyed in recent years has been based in part on recognition that acquiring and holding, at extremely low cost, a broadly diversified portfolio is an intelligent long-term strategy. (Bogle)
4. Investment policy (the allocation of assets) dominates investment strategy (market timing and security selection), explaining on average 93.6% of the variation in total pension plan returns. (Financial Analysts Journal, 1986).
5. Over time, a fund will, irrespective of past performance, inevitably revert toward the mean. Superior results in the past are unlikely to have superior results in the future. (Ellis) Given this reality, the search for market-beating long-term returns has been frustrated. (Bogle) A study has shown that if you sell the top performing mutual funds each year and buy the worst performing mutual funds, you'll outperform the average mutual fund by a significant margin (reversion the mean).

Conclusions (Mine)

1. The Deferred Comp Board should concentrate on helping participants determined their proper asset mix of their portfolio (percentages of stocks, bonds and money markets) that fits their risk tolerance and return requirements given their age and individual circumstances, and urge them to stay the course.
2. There are too many dangers in recommending individual actively managed mutual funds to Deferred Comp participants which we've seen over the last year. These dangers include underperformance, management changes and legal problems.

3. It is not good when we have to close a fund (Dreyfus Third Century with 2% of the total funds of the program) or wall off with the intention to close a fund (Janus with 10% of the funds and T. Rowe Price International Stock Fund with 5% of the assets).
4. With index funds, you don't have to worry about "out of sample" investment blowups that could permanently destroy the performance of an individual mutual fund.
5. The nice part about all of this is that we're most of the way there. We have index funds in most asset classes

<u>Suggestions</u>

1. Don't add anymore actively managed mutual funds to the stable of funds.
2. Replace funds that we close with index funds.
3. Fill in the holes in our stable of funds to give a complete, layered menu of funds (see attached, proposed funds are shaded).

   Passive – Vanguard or Barclays low cost index funds
   DFA – Low cost enhanced index funds
   Active – Schwab access to all active funds.

   As you can see from the attached sheet, I would only eliminate Janus and T. Rowe Price International Fund which are currently underperforming and under review. I would add 6 new funds, all of which would be in the Vanguard, Barclays or DFA family of funds which we already hold. We would keep 14 of the current offerings.
4. Have NRS review the funds of Vanguard and Barclays for the appropriate index funds in each sector of the markets we want to offer.
5. Have NRS review the DFA group for appropriate funds to offer in each sector of the markets we want to offer. I'm not that familiar with DFA, but they appear to be enhanced index funds.
6. Keep those active funds that are currently outperforming.