

# INVESTMENT SECTION

## Md. pension system busy buying stocks

9-2-98

'We don't look at interday events,' executive director says

By ERIKA NIEDOWSKI  
SUN STAFF

After Monday's 512-point stock market collapse, Richard N. Dixon, state treasurer and newly elected chairman of the board of trustees for the Maryland Retirement and Pension System, sent a simple message to the retirement system's executive director: Buy, buy, buy.

"We don't look at interday events," said Peter Vaughn, the recipient of that message, who was optimistically weighing which stocks to add to the state's portfolio even before the market closed up 288 points yesterday.

"What we look at are the fundamentals — are the fundamentals deteriorating in the market? — and we don't see that."

Even as investors big and small sent the stock market into a tailspin earlier this week by rushing to unload some of their assets during this time of international instability, a number of Maryland's long-term, more conservative investors seem to be holding steady.

And, like Vaughn, some are even taking advantage of what might be considered a "Red-Dot" sale on stocks.

Diane Camper, public af-

fairs manager for the Annie E. Casey Foundation, one of the largest philanthropic foundations in the state, said AEC is in the stock market for the long haul, meaning that drastic one-day shifts in the market — in either direction — don't warrant similarly drastic reactions.

The Casey Foundation, which focuses on national children's issues from its headquarters in Baltimore, currently has about \$1.4 billion in assets, thanks in part to the bull run in stocks. Of course, what goes around can also come around: A sharp decline in a foundation's assets, triggered by a full-fledged market crash, could have a substantial impact on that group's gift-giving activities.

In Casey's case, more than 60 percent of its holdings are in United Parcel Service, which does not trade publicly.

The rest of its portfolio, explained Camper, is fairly diverse. "I think there's a sense that we're pretty well diversified to withstand these periodic shocks," she said.

Vaughn, the pension system's executive director, said Maryland's \$28 billion pension account is protected from volatile market forces — even as much as a 25 percent correction over the course of a year. Now, though, Vaughn sees a chance to jump on some bargain gains. "This is a buying opportunity."

## State Police Retirement System

The General Assembly added a third benefit system, the State Police Retirement System, in 1949. Membership in the police system is restricted to uniformed employees of the Maryland State Police. The mission of the Maryland State Police is to fulfill its role as the state's lead coordinating law enforcement organization with commitment to pride, equality, respect and dignity. More than 1,600 officers throughout 23 counties strive to improve the quality of life for the citizens of Maryland by ensuring public safety.

# Chief Investment Officer's Report

## Investment Objectives

The Board of Trustees (the "Board") is charged with the responsibility of managing the assets of the State Retirement and Pension System. The Board is required to discharge its fiduciary duties solely in the interest of the participants, with the care, skill and diligence, which a prudent person would ordinarily exercise under similar circumstances. This standard of care not only permits but encourages diversifying investments across various asset classes.

Investment objectives are designed to support fulfillment of the Agency's mission — to optimize risk-adjusted returns in order to ensure timely payment of benefits to members and beneficiaries.

Investment objectives are implemented according to investment policies developed by the Board. The prudent person standard allows the Board to establish investment policies based on investment criteria that it defines, and it allows the Board to delegate investment authority to investment professionals.

System assets are managed by internal portfolio managers and external investment management firms, who employ both active and passive strategies. Investment management firms are selected and retained based on rigorous performance and organizational factors. Firms engaged must have a demonstrated track record and clearly defined and applied investment philosophy.

The long-term investment objectives established by the Board have been to achieve a real rate of return of at least 2.5% and a nominal rate of return which equals or exceeds the 8.0% actuarial return assumption. Implicit in the actuarial assumption has been earning a total rate of return that exceeds the nation's inflation rate by at least 2.5% over an extended period of time. The System is a long-term investor, and consequently, long-term results are emphasized over short-term gains.

Asset allocation is a key determinant of a successful investment program, and it is credited with being responsible for determining as much as 90% of a pension plan's total return in a given year. Asset allocation is the process, which results in the weightings assigned to each asset class. The Board takes both asset and liability side considerations into account when reviewing asset allocation.

From an asset side perspective, the Board reviews and approves the CAPM assumptions (Capital Asset Pricing Model), including the risk and return projections for each asset class as well as the correlations among the asset classes. Diversification is

achieved by combining asset classes, which are not perfectly correlated with each other. This may result in offsetting a market decline in one asset class with appreciation in another asset class. The benefit of this diversification is a reduction in the volatility of the total portfolio's investment performance.

From the liability side perspective, the Board works closely with its actuary and incorporates its funded status when determining its risk posture. Avoiding adverse contribution experience is an important consideration.

Multiple scenarios for possible asset mixes are reviewed. This process results in ranges which are approved by the Board for each asset class, and the targets are typically the mid-points of the ranges. As of June 30, 2000, the approved ranges for each asset class were:

Asset Class	Allowable Ranges
<b>Equity</b>	<b>up to 80%</b>
Domestic Equity	40-60%
International Equity	
EAFE	15-30%
Emerging Markets	0-4%
Alternative Investments	0-1%
Real Estate	2-7%
<b>Fixed Income</b>	
Domestic Investment Grade	10-30%
Domestic High Yield	0-5%
Cash Reserves	0-5%

## Capital Market Overview

During the fiscal year, most of the primary capital markets, which the Trust invested in achieved positive investments returns. Overall, broad equity markets out performed fixed income markets in the first half of the fiscal year (the second half of 1999), and this trend reversed itself in the second half of the fiscal year (the first half of 2000). The capital markets continued to experience volatility, and certain asset classes generated better performance than others.

The markets were highly sensitive this year to the release of economic data and to Federal Reserve policy changes. The Federal reserve raised interest rates (the Fed Funds rate) six times to close the fiscal year at 6.5%. Unemployment closed the month of June at 4.0%, and oil prices surged during the year, driving the energy component of the CPI (Consumer Price Index). The Euro also fell below parity with the U.S. dollar during the fiscal year as speculation on European Central Bank intervention caused the Euro to rally versus the U.S. dollar.

The following chart displays the fiscal year performance for some of the Trust's key benchmarks:

Benchmarks	FY 2000 Performance
<b>Equity Markets</b>	
<b>U.S. Equities</b>	
S&P 500	7.2%
Russell 2000	14.3%
CSFB Convertible Securities	30.0%
<b>International Equities</b>	
MSCI EAFE	17.2%
SSBI Extended Market	18.4%
MSCI Emerging Markets	9.5%
<b>Bond Markets</b>	
<b>U.S. Bond Markets</b>	
SSBI Broad Investment Grade	4.5%
CSFB High Yield Upper Tier	3.4%
<b>Non-U.S. Bond Markets</b>	
SSBI World Government Bond	5.7%
<b>Real Estate</b>	
Russell NCREIF (1 quarter lag)	11.6%
Wilshire Real Estate Securities	4.5%
<b>Short-Term Markets</b>	
91-Day treasury bill	5.2%

U.S. equity markets were led by the information technology (up 47.2%) and health care (up 14.1%) sectors. The materials sector (down 22%) was the worst domestic equity performer, and growth stocks outperformed value stocks. International equities were led by gains in Finland and Sweden due to strength of the telecom giants. Ireland was the worst performing developed market, falling 19%. Emerging markets turned in mixed performance for the component countries, with the index as a whole rising 9.5%. Turkey, in particular, surged 118% due to its bid to join the Euro region.

With regard to fixed income, the U.S. bond market saw the yield curve invert for the first time since 1990. The spread between 2 and 30-year U.S. Treasury securities closed the fiscal year at -46 basis points. The FOMC (Federal Open Market Committee) rate hikes pushed shorter maturities higher, and the high yield was the only sector to fall (down 1.0%). International bond markets continued to converge on the heels of the Euro.

## Investment Performance

The investment program achieved good performance this year with a total return for the fiscal year of 11.9%. This return exceeded both the actuarial target of 8% and the real return target of 2.5%. Performance is calculated using the time-weighted rates of return in compliance with AIMR (Association

for Investment Management and Research) standards. Rolling total returns for 3, 5, 10-year periods were 11.9%, 13.7%, and 12.3% respectively. Total return includes interest and dividends as well as capital appreciation.

The fair value of System assets increased from \$29.7 billion on June 30, 1999 to \$32.9 billion on June 30, 2000. The sources of this growth are primarily attributed to investment appreciation.

The System's equity investments returned 15.1%, with U.S. equities returning 11.2% and global equities returning 23.9% for the fiscal year. Convertible bonds also turned in good performance with an annual total return of 41.7% for the period ending June 30, 2000. This category is currently included under the equity allocation. The System's fixed income securities returned 4.4%. Real estate investments returned 9.4% for the one-year period ending March 31, 2000. Real estate is reported with a one-quarter lag to the rest of the investment portfolio.

The Trust's investment performance exceeded that of its benchmarks for all asset classes except fixed income. This was due to under performance in two areas — U.S. corporate bonds and global fixed income.

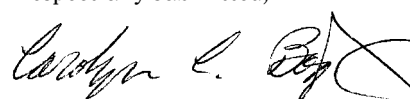
## Investment Activity

Fiscal 2000 was a busy year for the System. The Board reviewed and revised its asset allocation policy. The current policy is reflected under the Investment Objectives section of this report. This led to the elimination of two asset classes — emerging markets and global fixed income. The target for high yield bonds was increased to 3% of total assets.

Additional changes included: terminating several under performing managers, hiring three large capitalization value managers, funding three private equity fund of funds, and completing a high yield search.

With regard to proxy voting, Agency staff voted an estimated 1,500 ballots for approximately 1,200 U.S. companies. Votes for shares of commingled funds and international investments are typically delegated to the managers of those respective funds.

Respectfully submitted,



Carol Boykin, CFA  
Chief Investment Officer and  
Secretary to the Investment Committee

## Investment Portfolios by Manager as of June 30, 2000

(Expressed in Thousands)

	Fair Value	Investment Advisory Fees		Fair Value	Investment Advisory Fees
<b>Equity Managers</b>			<b>Fixed Income Managers</b>		
State Street Global Advisors	\$ 6,665,100	\$ 336	Internally Managed	\$ 5,430,461	N/A
Internally Managed	5,651,394	N/A	Pacific Investment		
Bank of Ireland			Management Company	1,188,925	2,574
Asset Management Limited	2,582,055	4,965	Standish, Ayer & Wood, Inc.	1,054,341	1,546
Credit Suisse Asset Management, LLC	1,328,449	3,092	W.R. Huff Asset Management Co., L.L.C.	324,835	1,344
Scudder Kemper Investments, Inc.	1,154,351	3,881	Other *	1,988	1,744
Templeton Investment Counsel, Inc.	946,959	2,715		<u>\$ 8,000,550</u>	<u>\$ 7,208</u>
Dimensional Fund Advisors Inc.	733,003	1,018	<b>Real Estate Managers</b>		
Capital Guardian Trust Company	714,441	388	LaSalle Investment Management		
The Capital Group, Inc.	601,134	5,107	Securities, L.P.	\$ 474,369	\$ 1,075
Harbor International Fund	535,604	3,746	LaSalle Investment Management, Inc.	257,148	2,188
Legg Mason Capital Management, Inc.	527,142	1,406	J.P. Morgan Investment		
GEM Capital Management, Inc.	391,908	1,223	Management, Inc.	163,922	1,304
Trust Company of the West	294,587	1,622	TimesSquare Real Estate Investors	146,638	1,416
Advent Capital Management	255,149	810	Internally Managed	141,264	N/A
Chapman Capital Management, Inc.	242,540	1,846	Sentinel Real Estate Corporation	59,359	685
Robert Torray & Co., Inc.	200,084	586	AEW Capital Management, L.P.	6,772	116
Brown Investment Advisory				<u>\$ 1,249,472</u>	<u>\$ 6,784</u>
& Trust Company	184,990	1,029	<i>* Investment managers no longer under contract as of 6/30/00.</i>		
Greenway Partners, L.P.	114,528	3,355			
Brown Capital Management, Inc.	110,344	1,171			
Relational Investors, LLC	107,533	756			
J. & W. Seligman & Co., Inc.	94,900	256			
The Edgar Lomax Company	89,555	240			
T. Rowe Price Associates, Inc.	70,856	422			
Harbour Vest Partners, LLC	23,989	501			
Brinson Partners, Inc.	6,612	638			
Abbott Capital Management, LLC	4,247	223			
Other *	100,841	4,907			
	<u>\$ 23,732,295</u>	<u>\$ 46,239</u>			

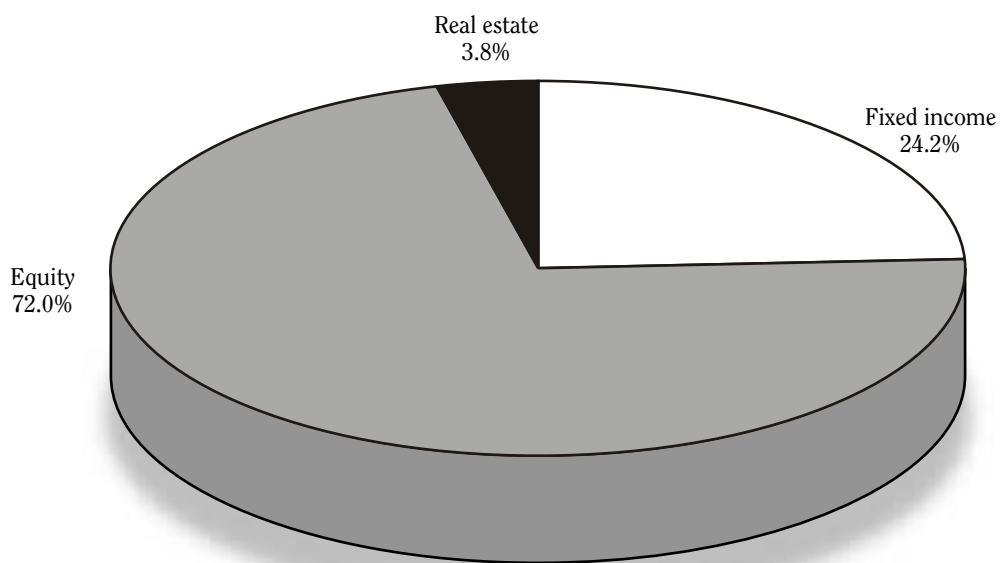
## Investment Portfolio Summary as of June 30, 2000 and 1999

(Expressed in Thousands)

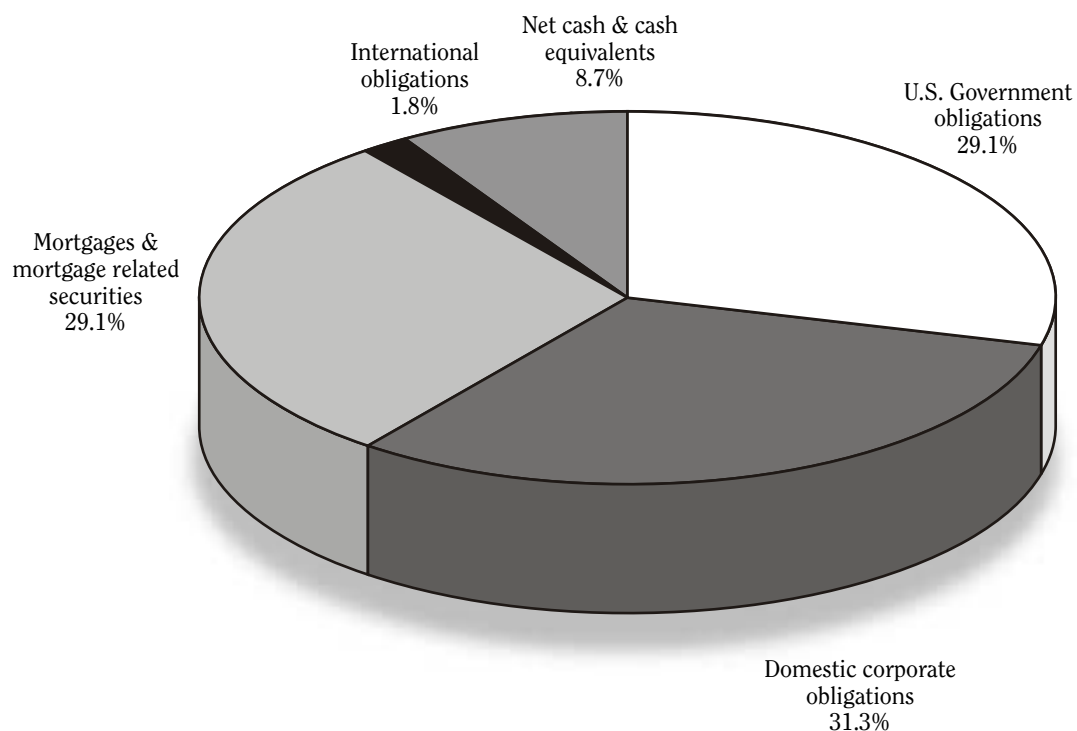
	2000		1999	
	Fair Value	% of Fair Value	Fair Value	% of Fair Value
<b>Fixed Income</b>				
U.S. Government obligations	\$ 2,330,615	7.0 %	\$ 2,788,318	9.3 %
Domestic corporate obligations	2,503,630	7.6	2,460,543	8.3
Mortgages & mortgage related securities	2,326,361	7.1	2,299,749	7.7
International obligations	144,240	0.4	700,289	2.4
Net cash & cash equivalents	695,704	2.1	174,832	0.6
* Total Fixed Income	<u>8,000,550</u>	<u>24.2</u>	<u>8,423,731</u>	<u>28.3</u>
<b>Equity</b>				
Domestic stocks	15,937,278	48.3	13,806,126	46.4
International stocks	6,867,162	20.8	6,070,162	20.4
Alternative investments	34,848	0.1	809	0.1
Net cash & cash equivalents	893,007	2.8	295,734	1.0
Total Equity	<u>23,732,295</u>	<u>72.0</u>	<u>20,172,831</u>	<u>67.9</u>
<b>Real Estate</b>				
Real Estate Investment Trusts	566,680	1.7	534,065	1.8
Pooled funds	376,690	1.1	345,037	1.2
Directly owned real estate	284,452	0.9	266,949	0.9
Net cash & cash equivalents	21,650	0.1	(5,649)	(0.1)
Total Real Estate	<u>1,249,472</u>	<u>3.8</u>	<u>1,140,402</u>	<u>3.8</u>
Total Portfolio	<u>\$ 32,982,317</u>	<u>100.0 %</u>	<u>\$ 29,736,964</u>	<u>100.0 %</u>

\* Security lending collateral payable has been netted against the actual collateral. The amounts net to zero.

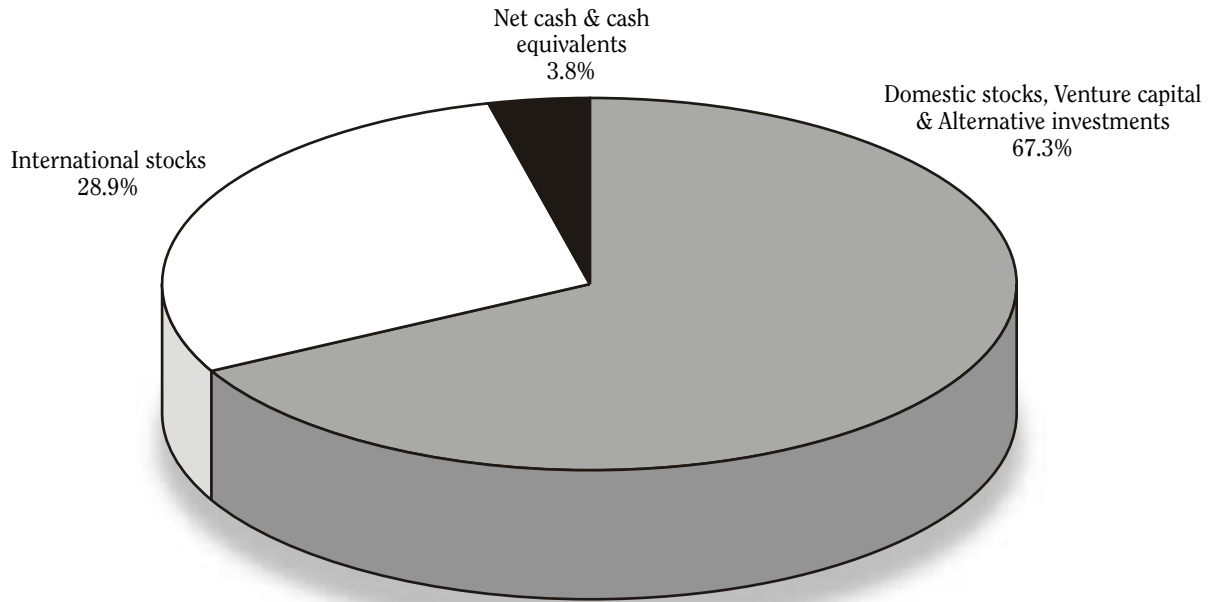
## Investment Portfolio Allocation as of June 30, 2000



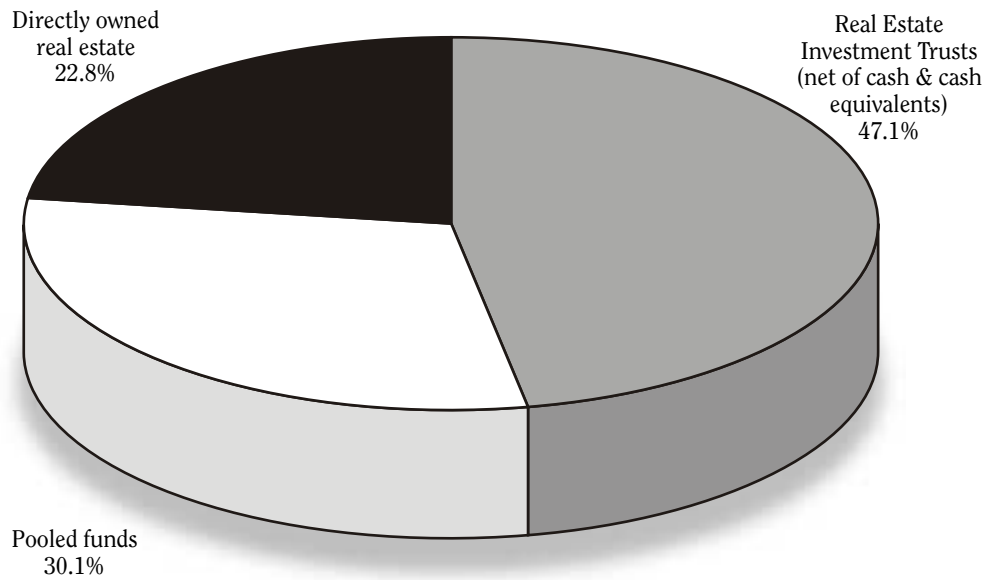
## Fixed Income Distribution by Type as of June 30, 2000



## Equity Distribution by Strategy as of June 30, 2000

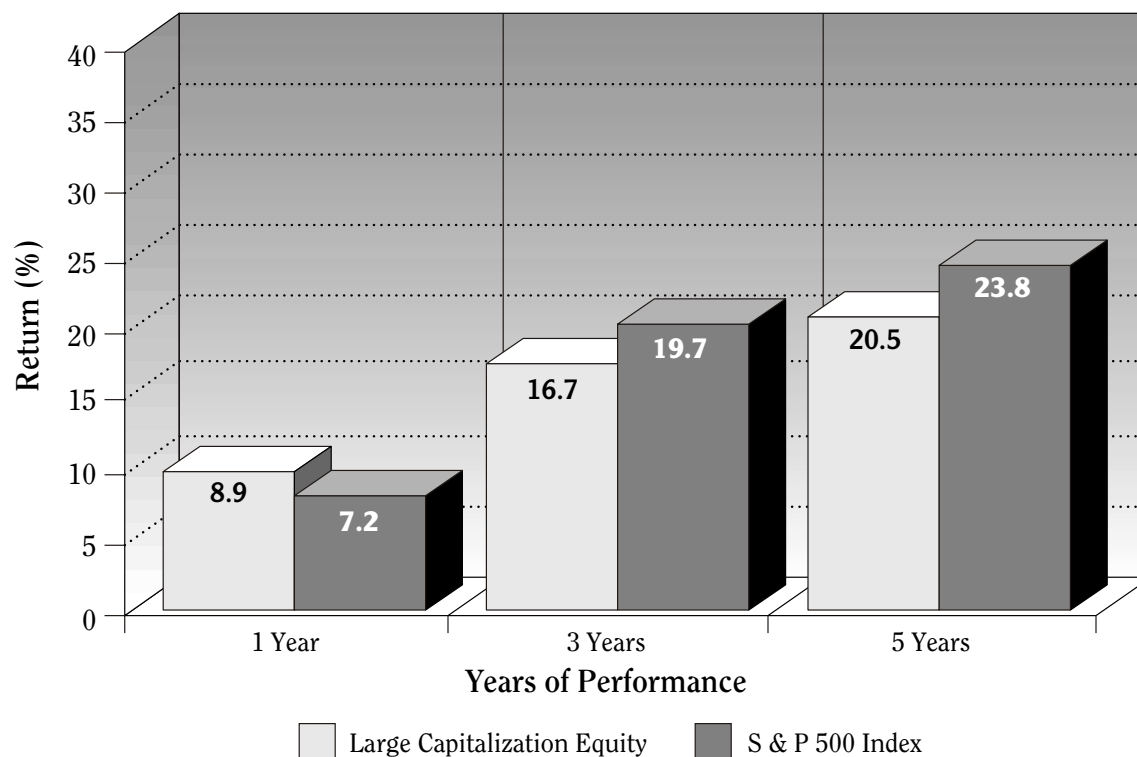


## Real Estate Distribution by Strategy as of June 30, 2000

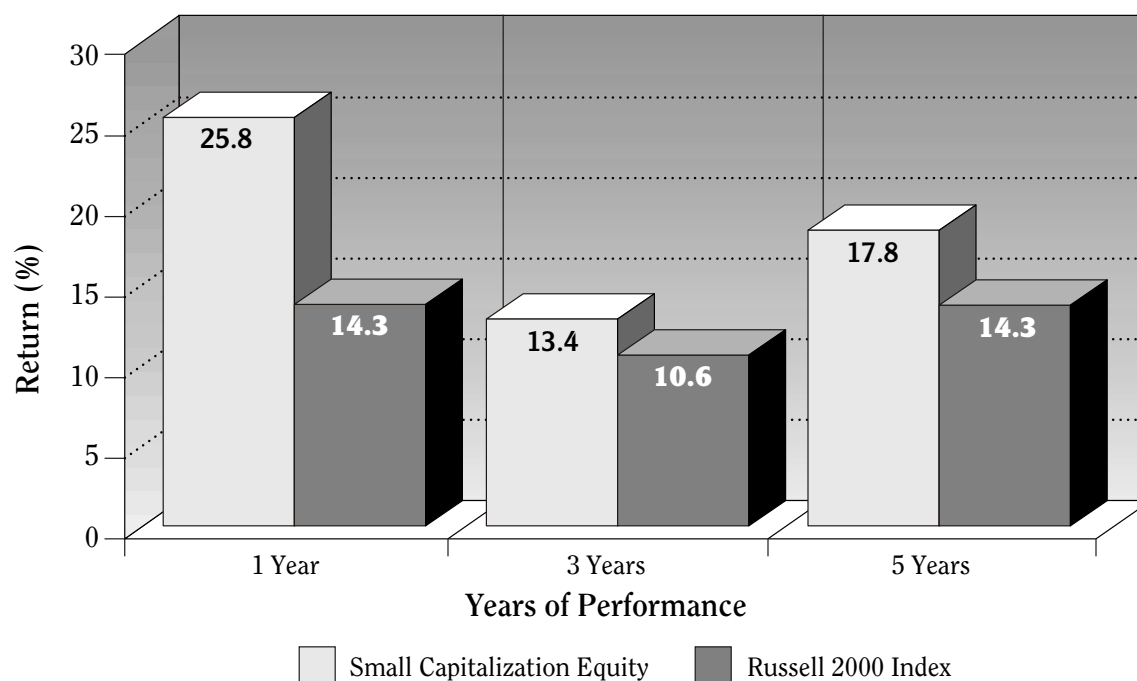


## Comparative Investment Returns Ending June 30, 2000

### Large Capitalization Equity

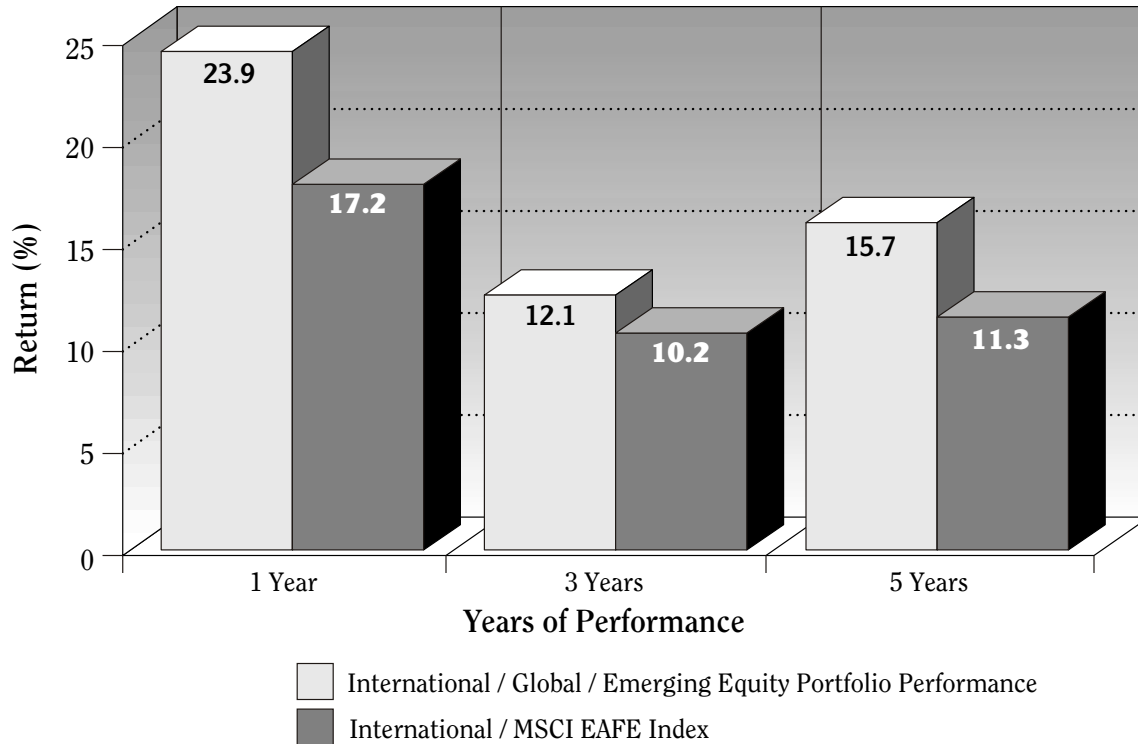


### Small Capitalization Equity

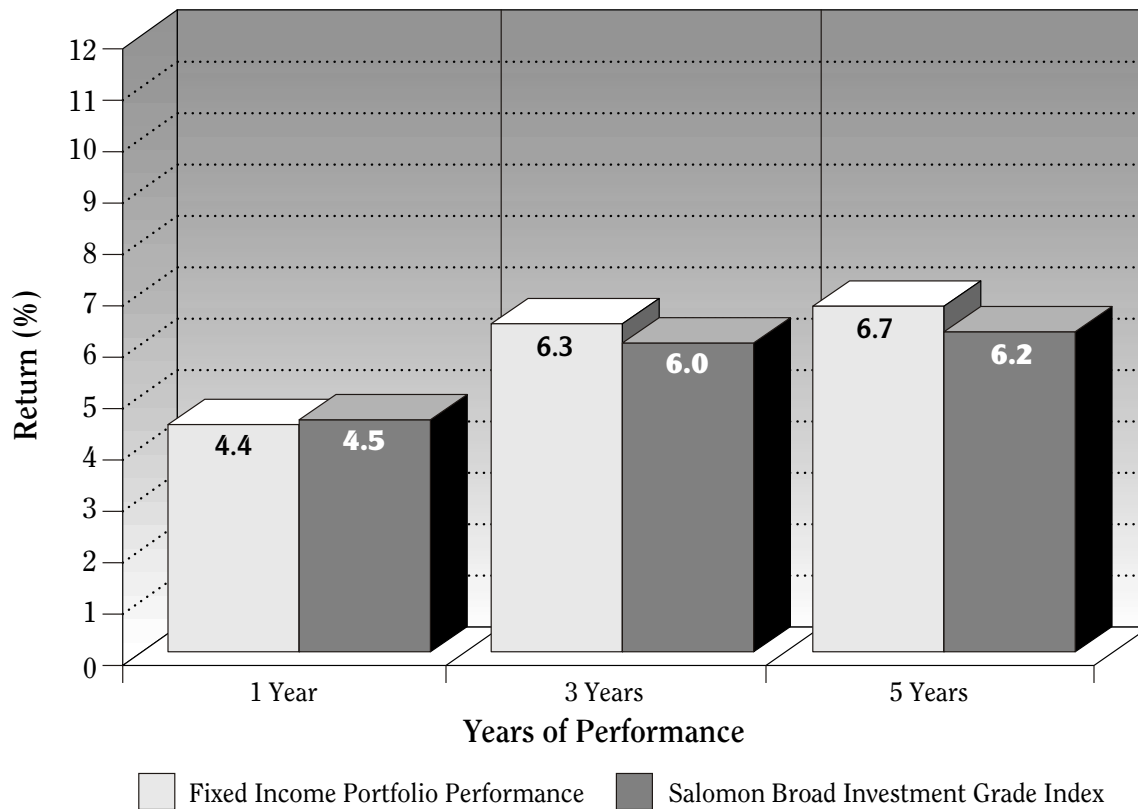


## Comparative Investment Returns Ending June 30, 2000

### International / Global / Emerging Equity

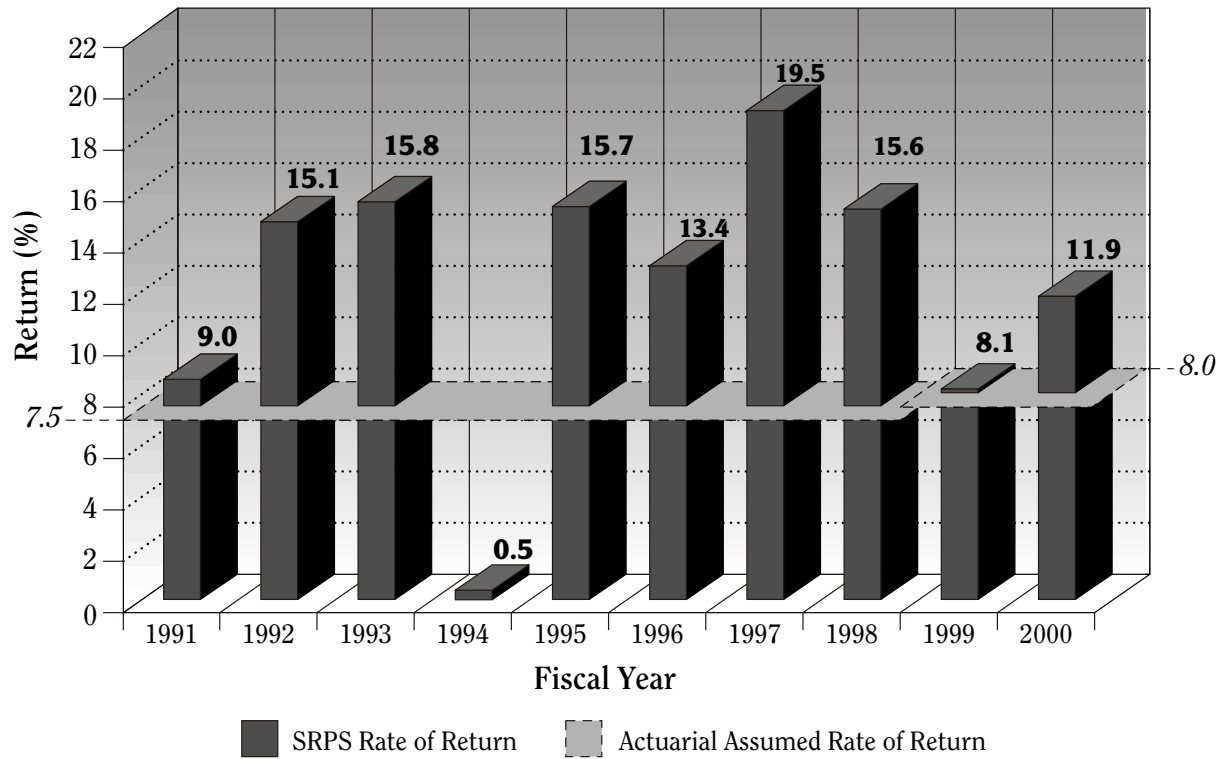


### Fixed Income

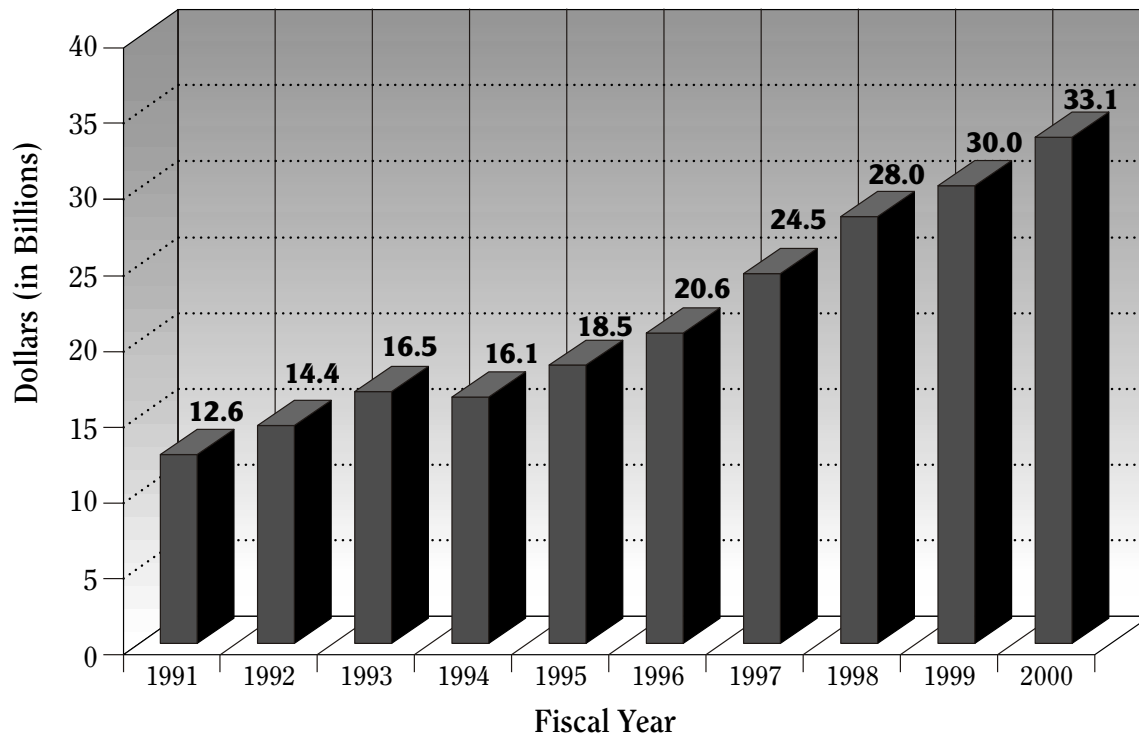




## Ten-Year History of Time-Weighted Annual Returns



## Ten-Year Growth of Investment Portfolio



## Largest 25 Holdings as of June 30, 2000

EQUITY INCOME SECURITIES:	No. of Shares	Fair Value
General Electric Company	9,005,900	\$ 477,312,700
Intel Corporation	3,029,000	404,939,438
Cisco Systems, Inc.	6,265,321	398,239,462
Microsoft Corporation	4,754,800	380,384,000
Pfizer, Inc.	5,621,075	269,811,600
Wal-Mart Stores, Inc.	4,064,900	234,239,863
Oracle Corporation	2,576,274	216,568,033
Vodafone Airtouch	49,913,218	201,754,748
International Business Machines Corporation	1,810,500	198,362,906
Nortel Networks Corporation	2,727,440	186,147,780
Lucent Technologies, Inc.	2,935,018	173,899,817
Merck & Co., Inc.	2,073,638	158,892,512
EMC Corporation	1,936,300	148,974,081
America Online, Inc. Del.	2,652,400	139,914,100
Johnson & Johnson	1,363,500	138,906,563
ING Groep NV	2,001,147	135,814,041
Sun Microsystems, Inc.	1,437,640	130,735,388
Exxon Corporation	1,645,939	129,206,212
Coca-Cola Company	2,240,800	128,705,950
Dell Computer, Inc.	2,576,700	127,063,519
Total Fina Elf	775,241	119,347,876
Bristol-Myers Squibb Co.	1,974,250	115,000,063
Citigroup, Inc.	1,859,322	112,024,151
Eli Lilly and Company	1,053,700	105,238,288
Home Depot, Inc.	2,061,824	102,962,336
TOTAL		<u>\$ 4,934,445,424</u>

FIXED INCOME SECURITIES:	Par	Fair Value
Federal Home Loan Bank, 5.80% due Sept. 2, 2008	\$ 239,350,000	\$ 219,677,824
Federal National Mortgage Assn. Princ. Strip, 0.00% due Feb. 15, 2008	265,500,000	161,291,250
Federal National Mortgage Assn. Remic, 6.50% due Dec. 25, 2022	141,149,000	136,692,926
United States Treasury Bonds, 12.00% due Aug. 15, 2013	92,950,000	125,497,372
GNMA I TBA, 6.50% due Dec. 15, 2099	109,920,000	104,320,675
Grand Metro Investment Corp., 0.00% due Jan. 6, 2004	129,725,000	100,407,150
United States Treasury Notes, 5.875% due Nov. 30, 2001	95,000,000	94,213,400
Citibank Credit Card Master Trust, 5.7907% due Feb. 7, 2003	96,500,000	92,398,750
GNMA I TBA, 7.50% due Dec. 31, 2099	91,040,000	90,385,422
Federal National Mortgage Assn., 7.25% due May 15, 2030	80,000,000	81,749,600
United States Treasury Notes, 5.625% due Feb. 15, 2006	81,500,000	79,068,040
Citibank Credit Card Master Trust I, 0.00% due Aug. 15, 2006	101,500,000	75,598,154
Federal Home Loan Mortgage Corp., 8.0714% due Nov. 15, 2021	71,565,000	73,085,756
Federal Home Loan Mortgage Corp., 5.125% due Oct. 15, 2008	79,500,000	69,549,780
Federal National Mortgage Assn. Remic, 6.50% due Nov. 28, 2023	63,711,000	61,879,309
United States Treasury Notes, 6.125% due Aug. 15, 2007	61,900,000	61,503,221
GNMA I TBA, 8.50% due Dec. 31, 2099	57,350,000	58,721,239
Deutsche Ausgleichbk, 5.125% due Sept. 22, 2003	60,000,000	56,328,000
United States Treasury Bonds, 8.125% due Aug. 15, 2019	39,500,000	47,720,740
United States Treasury Notes, 5.25% due May 31, 2001	45,000,000	44,514,900
Prudential-Bache CMO Trust, 8.485% due Oct. 20, 2020	43,020,260	43,826,890
Federal Home Loan Mortgage Corp., 6.00% due May 15, 2017	46,200,000	42,922,572
United States Treasury Bonds, 8.875% due Feb. 15, 2019	31,200,000	40,131,000
GMNA Pool 002795, 6.50% due Aug. 20, 2029	42,443,204	40,082,513
Federal Home Loan Mortgage Corp., 6.45% due April 29, 2009	42,800,000	39,884,036
TOTAL		<u>\$ 2,041,450,519</u>

A complete list of portfolio holdings is available upon request.

## Commissions to Brokers

### for the Fiscal Year Ended June 30, 2000

(Expressed in Thousands)

Brokers *	Total Shares	Total Commission	Commission Per Share
State Street Brokerage	75,243	\$ 1,292	\$ 0.017
Merrill Lynch & Co.	285,781	1,246	0.004
Morgan Stanley Dean Witter & Co.	33,068	1,175	0.036
Salomon Smith Barney, Inc.	47,062	1,118	0.024
Goldman Sachs & Co.	67,376	990	0.015
SBC Warburg Dillon Read	101,902	745	0.007
Lehman Brothers, Inc.	17,642	732	0.041
Deutsche Bank AG	276,697	655	0.002
Dresdner Kleinwort Benson	23,360	584	0.025
BHF Bank	26,711	518	0.019
HSBC Securities	20,096	507	0.025
Credit Suisse First Boston	19,165	442	0.023
Investment Technology Group, Inc.	13,346	307	0.023
J.P. Morgan Securities, Inc.	3,096	241	0.078
ABN Amro	11,474	238	0.021
Jefferies & Company	3,983	224	0.056
Bear Stearns & Co.	9,140	224	0.024
Instinet Corp.	11,044	220	0.020
Donaldson Lufkin & Jenrette, Inc.	4,999	187	0.037
Ferris Baker Watts	3,378	185	0.055
Exane	789	176	0.223
Weeden & Co.	3,012	150	0.050
Robert Fleming & Co.	6,786	137	0.020
May Davis Group	2,157	129	0.060
ING Baring Securities, Ltd.	4,737	122	0.026
Morgan Guaranty Trust Co.	842	122	0.144
Paine Webber Group, Inc.	2,137	114	0.054
Cantor Fitzgerald	3,063	107	0.035
Legg Mason, Inc.	2,081	105	0.050
Credit Lyonnais	51,788	103	0.002
Cheuvreuxde Virieu	566	101	0.178
The Chapman Company	1,955	96	0.049
Nomura Securities Co. Ltd.	3,657	95	0.026
ODDO Finance	401	86	0.216
Other broker fees	130,130	2,814	0.022
Total broker commissions	<u>1,268,664</u>	<u>\$ 16,286</u>	\$ 0.013

\* Proceeds from the sale and disbursements for the purchase of securities are reported net of brokers' commissions. As such, brokers' commissions are not included as investment expenses on the Statements of Changes in Plan Net Assets. Other broker fees include 180 other brokers each receiving less than \$75,000 in total commissions.



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