

Update on Sub-Prime Mortgage Meltdown and State Board of Administration Investments

November 9, 2007

State Board of Administration of Florida



INVESTING FOR FLORIDA'S FUTURE

SBA-000708

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I. Introduction

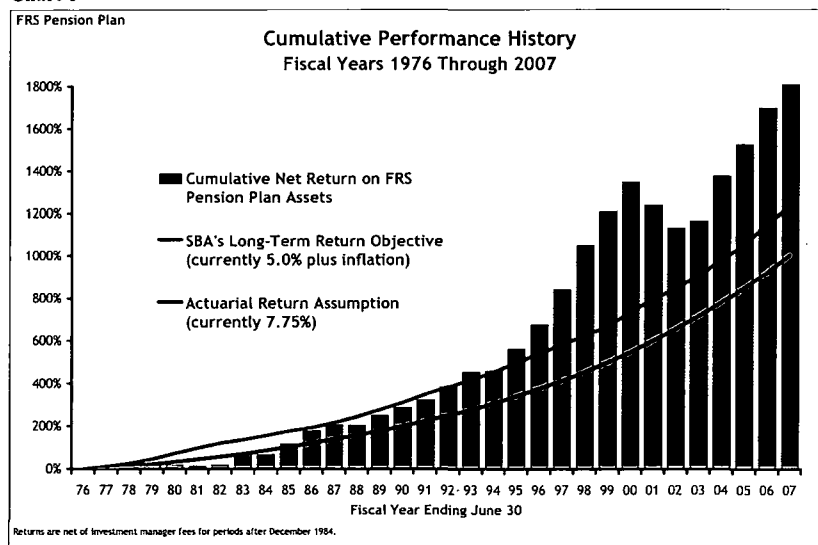
The State Board of Administration of Florida (SBA) is an investment management organization responsible for managing \$187.5 billion in governmental funds, including Florida's \$138 billion pension fund. Consistent with its fiduciary duties, the SBA continuously monitors its more than 300 investment portfolios. Operating under detailed investment policies and portfolio guidelines, the SBA maintains highly diversified investment portfolios. As a result, the SBA is well-positioned to sustain a disciplined long-term focus during periods of heightened financial market volatility and uncertainty.

The SBA's professional investment staff and external investment managers have exercised their fiduciary duties to prudently steward trust assets during a number of historical periods of financial stress. Further, they recognize that such periods will continue to occur due to the normal ebb and flow of global economic and financial forces.

1. The 1980s experienced energy shortages, savings and loan crises, economic recession, escalating inflation and double-digit interest rates;
2. In the 1990s, there was economic recession, 6% inflation, the Latin American debt crisis, the Mexican Peso devaluation, East Asian devaluations and Russian debt defaults;
3. So far this decade, the hallmark events have been the bursting of the technology bubble, the tragedies of September 11, and the current evolving sub-prime meltdown and contagion effects. The collapse of the technology bubble was followed by one of the deepest and longest bear markets since the Great Depression. Some are now concerned that the U.S. economy may be entering a recession and bear market. Others are equally concerned that persistent strong U.S. economic growth and a weak dollar will fuel inflation.

The SBA can take pride in the fact that its investments have held up well through periods of financial crisis and economic downturns (Chart 1). This report lays out our current exposures and responses to date dealing with the sub-prime meltdown. Although past performance is no guarantee of future results, and the financial environment may become even more challenging, we believe the SBA is positioned to deal with the current financial stress at least as well as we have with prior events. We will continue to work toward preserving the Florida Retirement System Pension Plan's status as having the highest funded ratio of large public pension plans in the nation, as well as prudently managing all of our investment mandates.

Chart 1



II. Executive Summary

Investor anxiety about the sub-prime issue continues to reverberate through the financial markets. As expected, we have been closely monitoring the SBA's assets for potential risks related to direct or indirect sub-prime exposure and believe that the financial markets may remain challenging for some time. We are pleased to report that the SBA's assets have continued to perform well in the face of heightened market uncertainty.

In summary:

1. Diversification is one of the most important investment risk controls, and the SBA's portfolios are highly diversified. In fact, the Florida Retirement System (FRS) Pension Plan Investment Policy Statement approved by the Trustees in May 2007 both increased diversification and lowered the level of absolute risk by about 13%.
2. On several occasions, the SBA has proactively reviewed funds under management for direct or indirect exposures to sub-prime residential mortgages. Each review has indicated immaterial direct exposure to sub-prime residential mortgages. We have nonetheless remained alert to managing indirect or spillover effects from the sub-prime sector.
3. The vast majority of the SBA's assets are in actively managed strategies that prudently manage risk while pursuing their return objectives. So far this fiscal year, the SBA has conducted about 230 meetings with public and private market active investment managers. A central topic in each of these meetings was their management of the risks related to sub-prime mortgage loans and possible contagion effects. Earlier this month, the SBA again reached out to its investment managers to assess the potential for sub-prime spillover effects to negatively impact SBA assets.
4. In the aggregate, the SBA's portfolios are defensively positioned with respect to the primary risks emanating from the sub-prime sector. Within the FRS Pension Plan, the domestic and foreign equities asset classes are underweight the industries that could be most negatively impacted by sub-prime contagion (e.g., homebuilding, banks, etc.). Similarly our fixed income investments are emphasizing higher credit quality and, under Florida statutes, the SBA can only directly invest in AAA-rated agency mortgage-backed securities (i.e., GNMA, FNMA and Freddie MAC). Our short-term portfolios are also selectively lowering exposures to asset-backed commercial paper and financial company securities in a prudent and orderly fashion.
5. Finally, the SBA's bond and money market investments have continued to maintain high overall credit ratings. The only disappointment has been with isolated credit downgrades impacting several short-term portfolios and accounting for about 4.7% of par value. However, we have participated in restructuring negotiations with two asset-backed commercial paper issuers to ensure that collateral is held in trust to pay principal and interest due the SBA's clients. No client of the SBA has ever lost money in a short-term portfolio, and we remain confident that our portfolios will continue to provide stable returns for clients with an emphasis on safety and liquidity of principal.

Chart 2

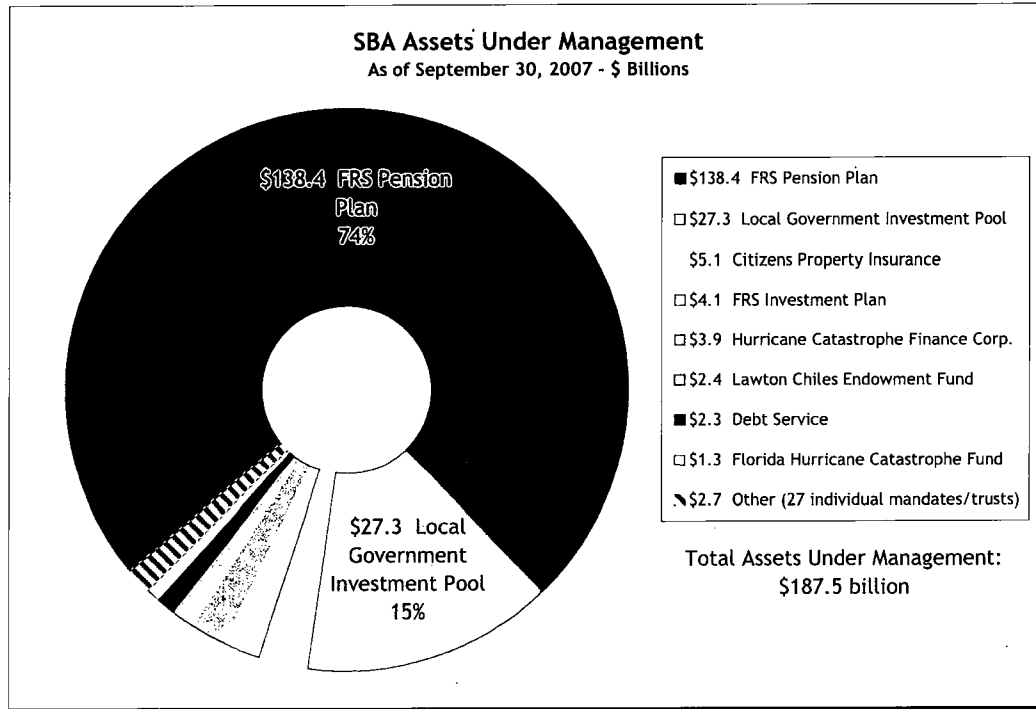


Chart 3

SBA Assets Under Management by Investment Vehicle - As of September 30, 2007

	(1)	(2)		(3)	(4)	(5)	(6)	(7)
	LGIP	CAMP-MM	CAMP-FI	CAMP-DE	Separately Managed Assets	Total Assets Under Management	Share of Total	
Portfolios With Separately Managed Assets								
1. FRS Pension Plan	-	-	-	-	138,438,587,159	138,438,587,159	73.82%	
2. Citizens Property Insurance	-	-	-	-	5,078,712,671	5,078,712,671	2.71%	
3. Florida Hurricane Catastrophe Finance Corp.	-	5	-	-	3,879,635,419	3,879,635,424	2.07%	
4. FRS Investment Plan	-	-	-	-	4,080,089,767	4,080,089,767	2.18%	
5. Lawton Chiles Endowment Fund	-	28,799,014	327,711,550	243,747,465	1,790,702,710	2,390,960,738	1.27%	
6. Debt Service	-	-	-	-	2,332,029,048	2,332,029,048	1.24%	
7. Florida Hurricane Catastrophe Fund	-	-	-	-	1,343,508,468	1,343,508,468	0.72%	
8. Department of the Lottery	-	1,099,835	-	-	1,270,271,723	1,271,371,557	0.68%	
9. Florida Prepaid College Fund	-	58,251,598	-	-	256,517,436	314,769,034	0.17%	
10. Local Government Non-Pool Funds	-	-	-	-	285,098,868	285,098,868	0.15%	
11. Retiree Health Insurance Subsidy	-	59,058,567	-	-	150,419,251	209,477,818	0.11%	
12. Scripps Florida Funding Corporation	-	3,014,345	-	-	185,629,943	188,644,287	0.10%	
13. Burnham Institute	-	780,206	-	-	113,472,611	114,252,817	0.06%	
14. Florida College Investment Plan	-	-	-	-	26,543,744	26,543,744	0.014%	
15. Torrey Pines Institute for Molecular Studies Fund	-	13,922,371	-	-	10,984,092	24,906,463	0.013%	
16. McKnight Doctoral Fellowship Program	-	1,591,799	-	1,067,686	230,956	2,890,441	0.002%	
17. Gas Tax Trust Fund ¹	-	-	-	-	-	0	0.00%	
18. Bond Proceeds Trust Fund ¹	-	-	-	-	-	0	0.00%	
Portfolios Invested Solely in SBA Investment Pools								
19. Local Government Investment Pool ²	27,268,602,440	-	-	-	-	27,268,602,440	14.54%	
20. Police and Firefighters' Premium Tax Trust Fund	-	86,335,725	-	-	-	86,335,725	0.05%	
21. FSU Research Foundation	-	-	39,085,116	43,410,890	-	82,496,006	0.04%	
22. SBA Administrative Fund	-	11,275,577	28,943,143	-	-	40,218,720	0.02%	
23. PEORP Administrative Fund	-	27,872,652	-	-	-	27,872,652	0.015%	
24. Insurance Capital Build-up Program	-	18,733,784	-	-	-	18,733,784	0.010%	
25. SRI International Fund	-	13,982,455	-	-	-	13,982,455	0.007%	
26. Florida Prepaid College Foundation	-	9,251,634	-	-	-	9,251,634	0.005%	
27. Pinellas Suncoast Transit Authority	-	-	6,101,926	-	-	6,101,925	0.003%	
28. Florida Division of Blind Services	-	41,865	925,253	1,597,367	-	2,564,486	0.001%	
29. Arbitrage Compliance Trust Fund	-	2,072,299	-	-	-	2,072,299	0.001%	
30. Fla. Endowment for Vocational Rehabilitation	-	2,119,859	-	-	-	2,119,859	0.001%	
31. Bond Fee Trust Fund	-	1,840,415	-	-	-	1,840,415	0.001%	
32. Fla. College Investment Plan Admin. Expense	-	555,570	-	-	-	555,570	0.0003%	
33. Fla. Prepaid College Fund Administrative Expense	-	439,864	-	-	-	439,864	0.0002%	
34. Investment Fraud Restoration Financing Corp.	-	27,668	-	-	-	27,668	0.00001%	
35. Inland Protection Financing Corporation	-	1,440	-	-	-	1,440	0.000001%	
Total Assets Under Management	\$ 27,268,602,440	\$ 341,068,547	\$ 402,766,987	\$ 289,823,408	\$ 159,242,433,865	\$ 187,544,695,247		

¹ The fund balance is periodically zero due to cash flows.

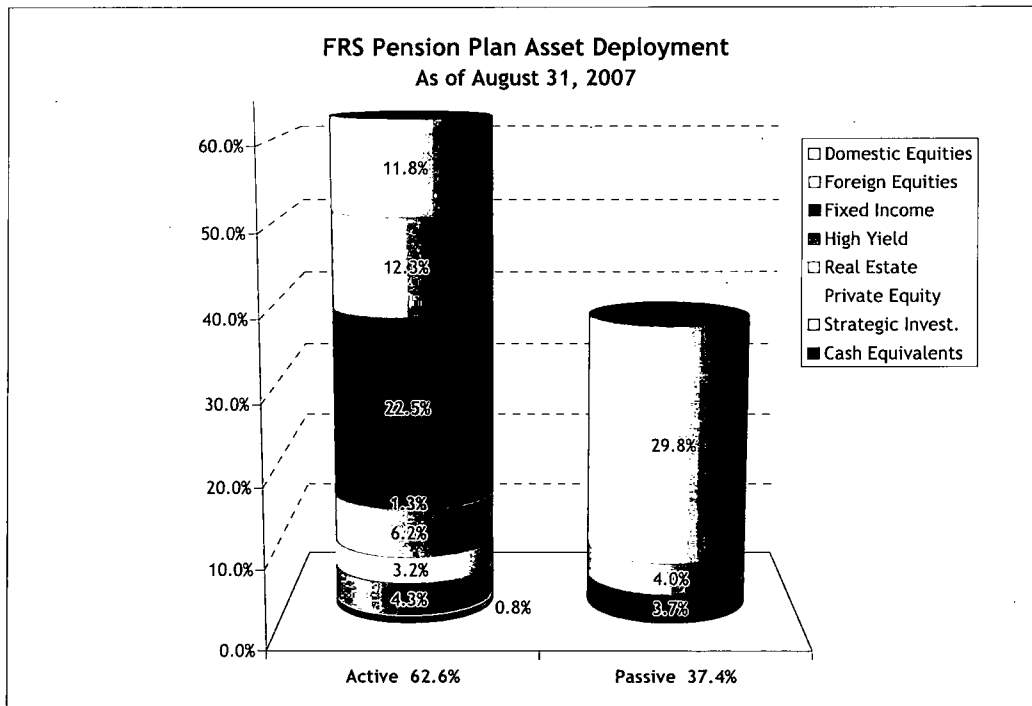
² Individual accounts are not shown. As of September 30, 2007 there were 2,168 individual accounts in the LGIP.

III. Recent Risk Monitoring Activities

The SBA regularly utilizes consultants, investment risk models, credit analysis and other analytics to review the risk exposures in funds under its stewardship. This analysis is essential to prudently managing the funds and overseeing external fiduciary investment managers that exercise discretion over the SBA's assets. Just within the FRS Pension Plan, there are about 140 portfolios (i.e., 80 public market investment portfolios and 60 private equity and real estate funds).

The vast majority of the SBA's assets are in actively managed strategies where experienced investment managers construct diversified portfolios by prudently managing risk factors in pursuit of their return objectives. Chart 4 illustrates the SBA's reliance on active management strategies for the FRS Pension Plan. The SBA regularly interacts with its investment managers to review their performance, investment process, organizational factors and market views regarding risks and opportunities. Since June 30, 2007, staff has conducted about 230 meetings with managers (not including unscheduled calls, etc.). A central topic in these meetings was their actual and planned management of the risks related to sub-prime mortgage loans and possible contagion effects.

Chart 4



Additionally, the SBA has engaged in several focused reviews of potential direct or indirect sub-prime exposures. In late July, the SBA reviewed its portfolios for exposure to equity tranches of collateralized debt obligations (CDO) based on sub-prime mortgages. No such exposure was identified. In early to mid August, the SBA reviewed exposure to CDOs backed by sub-prime mortgages. At that time:

1. Exposure to CDOs backed by sub-prime mortgages across the SBA's investment mandates was limited to a collective trust managed by a third-party fiduciary and was immaterial. The SBA had

less than \$3 million of a CDO backed by sub-prime mortgage exposure in a Defined Contribution Plan institutional money market fund.

2. Internally managed short-term portfolios had invested in CDOs backed by various types of high grade assets, including bank liquidity enhancements. An exposure analysis revealed that none of these CDOs were directly backed by sub-prime mortgage loans.
 - a. As of August 22, 2007, the SBA had roughly \$1.5 billion invested in CDOs in the FRS Pension Plan (i.e., Defined Benefit), Local Government Investment Pool, and trusts for separate account clients.
 - b. The CDOs had the highest short-term credit ratings from Moody's, S&P etc.
 - c. The CDOs were very short-term in nature and all but one matured in September. Currently, the SBA has only one CDO (rated A-1+/Aaa/AAA), with a par value of \$80 million, maturing in April 2008.

By August 22, all internally managed short-term and long-term fixed income portfolios had been reviewed, and they did not have any sub-prime exposure. SBA continued to evaluate other potential indirect sub-prime exposure across all externally managed investment portfolios. Areas of focus were:

1. Asset-backed Commercial Paper.
2. Asset-backed Securities, including those backed by home equity loans.
3. Corporate debt issued by sub-prime mortgage originators.

The cumulative review indicated:

1. The only exposure to sub-prime loans through these three categories of instruments was in the Defined Contribution Plan, and this exposure was less than 0.5% of total plan assets and almost entirely through AAA-rated floating rate securities (i.e., with credit enhancements). As of early November, these exposures had declined to less than 0.4% of plan assets.
2. The SBA had exposure to A1/PI-rated Asset-backed Commercial Paper that was backed by high grade collateral. As of late August, most of these investments had been recently affirmed by the rating agencies. However, two were on credit watch by the rating agencies because of liquidity concerns. The SBA believed the investments remained sound from a credit quality perspective and was in active negotiations with other senior note holders and the administrator to extend the maturity of the investments until the liquidity crisis subsided and the markets normalized. Section V provides a detailed update on these exposures.

On August 23, the SBA's internal Senior Investment Group and consultants from Ennis, Knupp + Associates and Wilshire Associates formally discussed the following agenda items:

1. Impact of recent market volatility on asset class performance and portfolio management;
2. Material sectors/instruments that are receiving particular focus from the asset class and/or portfolio managers due to perceptions of heightened risk; and
3. Tactics being used to manage, mitigate, avoid, or exploit the recent market volatility and changes in relative valuations.

Since that meeting, the SBA has continued to work with its investment managers to monitor the risk exposures. The managers were recently surveyed regarding exposures to specific sub-industries and companies sensitive to the sub-prime contagion, particularly focusing on:

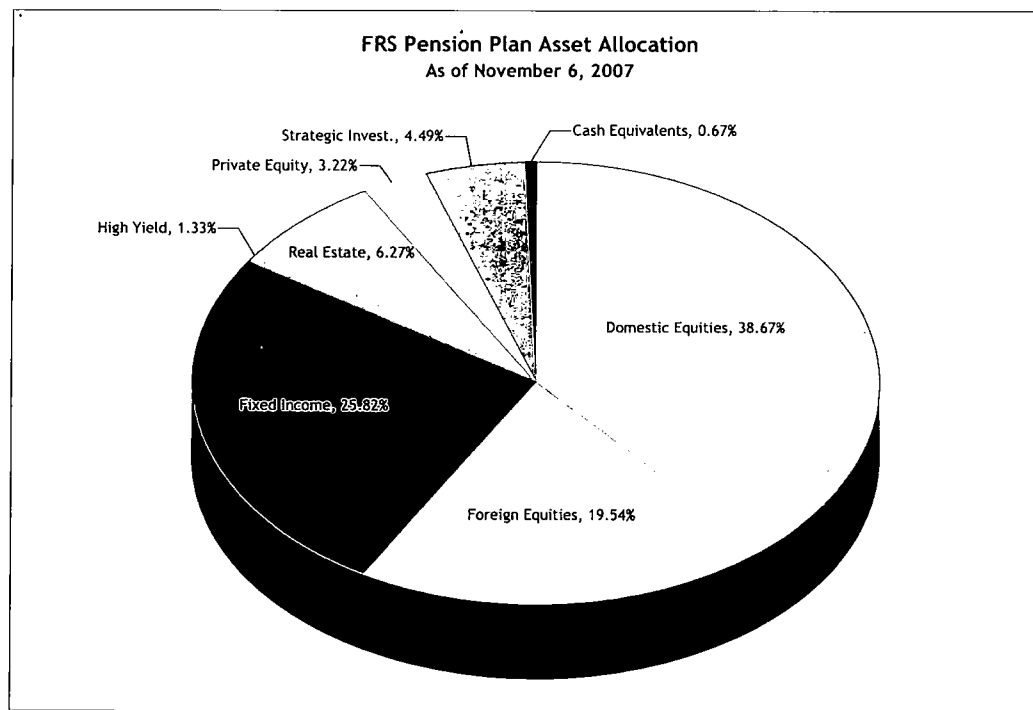
1. How the account is positioned to manage, mitigate or avoid the recent market volatility and changes in relative valuations created by the evolving sub-prime-related turbulence and potential contagion effects; and
2. The firm's view of the materiality and likelihood of additional contagion effects impacting the performance of the broader financial markets or financial system.

IV. Review of the Pension Plan

The Florida Retirement System Pension Plan Trust Fund has assets of approximately \$138 billion broadly diversified across the asset classes shown in Chart 5. The Fund's asset allocation is the most important determinant of both short-term and long-term investment returns and risk. Of note, the Investment Policy Statement approved in May 2007 lowered the level of risk in the portfolio by about 13%. This was accomplished by increasing the Fund's allocation to bond-type assets and lowering the allocation to equity-type assets (i.e., 78%/22% to 69%/31%, representing a 9% shift). Diversification within equities was also improved by increasing the allocation to foreign equities and adding small cap foreign equities exposure.

Diversification is further enhanced because asset classes closely track broad market indexes: e.g., 3,000 securities in domestic equities, 10,400 securities in investment grade and high yield bonds, 5,400 securities in foreign equities, 2,500 securities in global equities etc. Finally, diversification is enforced within a portfolio context by guidelines limiting certain concentrations/exposures; e.g., single position/issuer limits, industry/sector limits, etc.

Chart 5

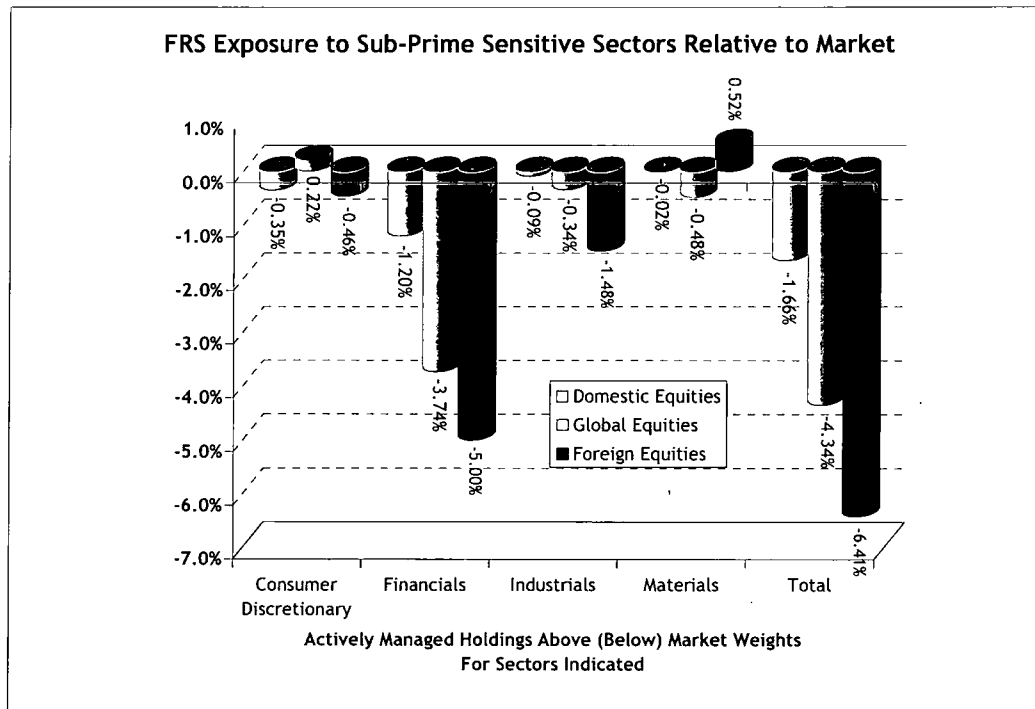


Despite lowering the Fund's overall risk level this past summer, the Fund is still expected to provide long-term average returns of 5% per year in excess of inflation. However, the advantage of less total fund risk is a lower probability of:

- Disappointing investment performance;
- Higher employer contributions; and
- Deterioration of the current surplus.

In the aggregate, the FRS Pension Plan is defensively positioned with respect to the primary risks emanating from the sub-prime sector. The equities asset classes, constituting about 63% of the Fund, are underweight the industries that could be most negatively impacted by spillover from the sub-prime problems. Staff and investment managers identified 32 sub-industries within the consumer discretionary, financials, industrials and materials sectors and measured the active managers' cumulative positions relative to the neutral market weightings.¹ Chart 6 shows a material defensive posture in the three main groupings of public market equity investments in the Fund.

Chart 6



¹ The sub-industries were: Consumer Electronics, Home Furnishings, Home Improvement Retail, Homebuilding, Home Furnishing Retail, Household Appliances, Specialized Consumer Services, Asset Management & Custody Banks, Consumer Finance, Diversified Banks, Diversified REITs, Industrial REITs, Investment Banking & Brokerage, Mortgage REITs, Multi-Line Insurance, Multi-Sector Holdings, Office REITs, Other Diversified Financial Services, Property & Casualty Insurance, Real Estate Management & Development, Regional Banks, Residential REITs, Retail REITs, Specialized Finance, Specialized REITs, Thrifts & Mortgage Finance, Building Products, Construction & Engineering, Construction & Farm Machinery & Heavy Trucks, Electrical Components & Equipment, Construction Materials, Forest Products.

Similarly, the Fund's bond investments have a higher credit quality than the general market (Charts 7 and 8). These bond portfolios have a market weight to securitized assets but, under current Florida statutes, the SBA can only directly invest in AAA-rated agency mortgage-backed securities (i.e., GNMA, FNMA and Freddie MAC). The presence of Caa-rated bonds in the high yield asset class primarily represents split-rated bonds (84%), and none of the holdings are related to the 32 sub-industries identified above.

Chart 7

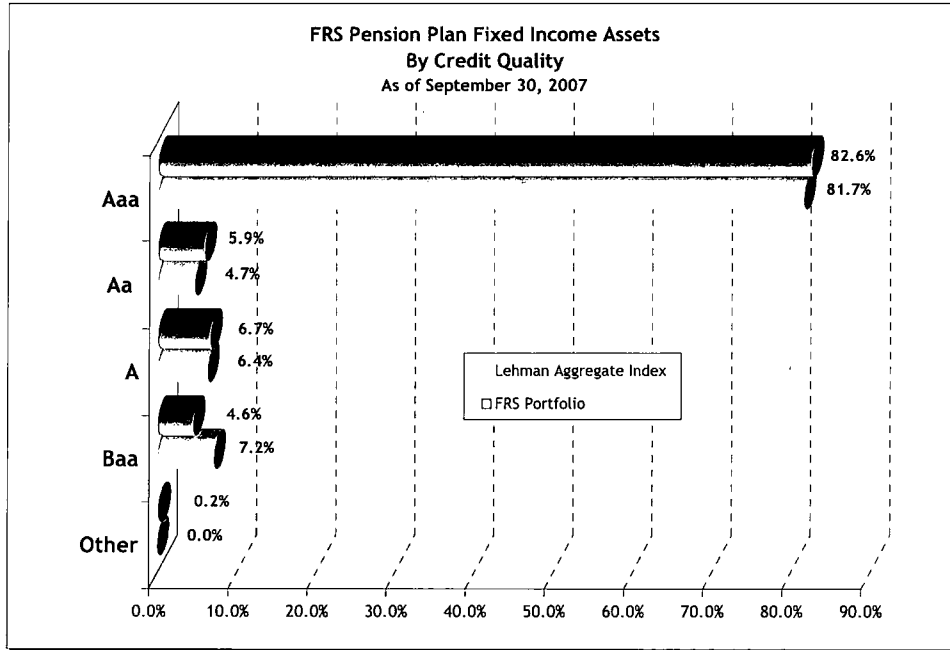
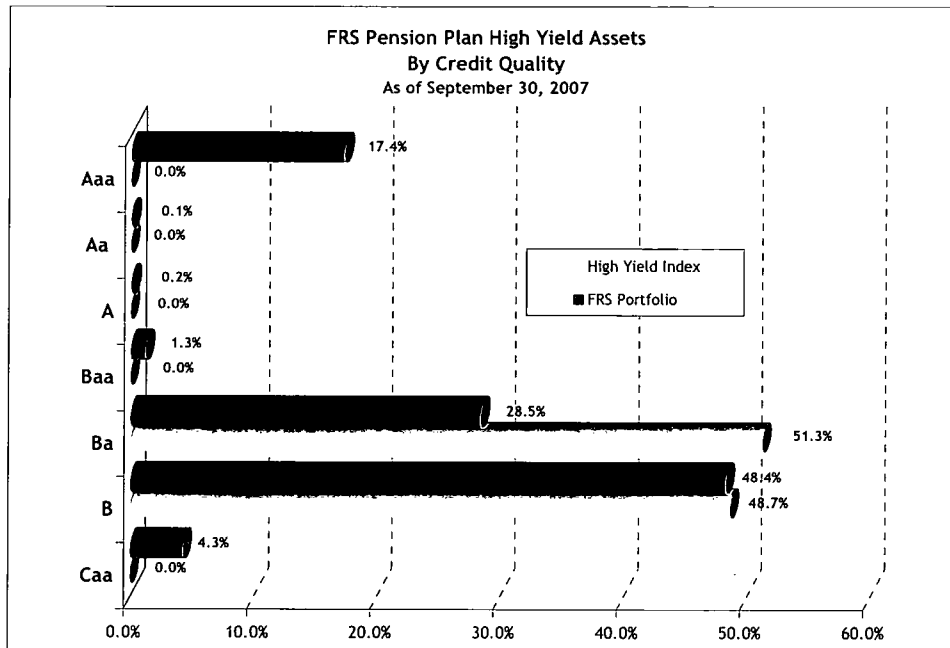
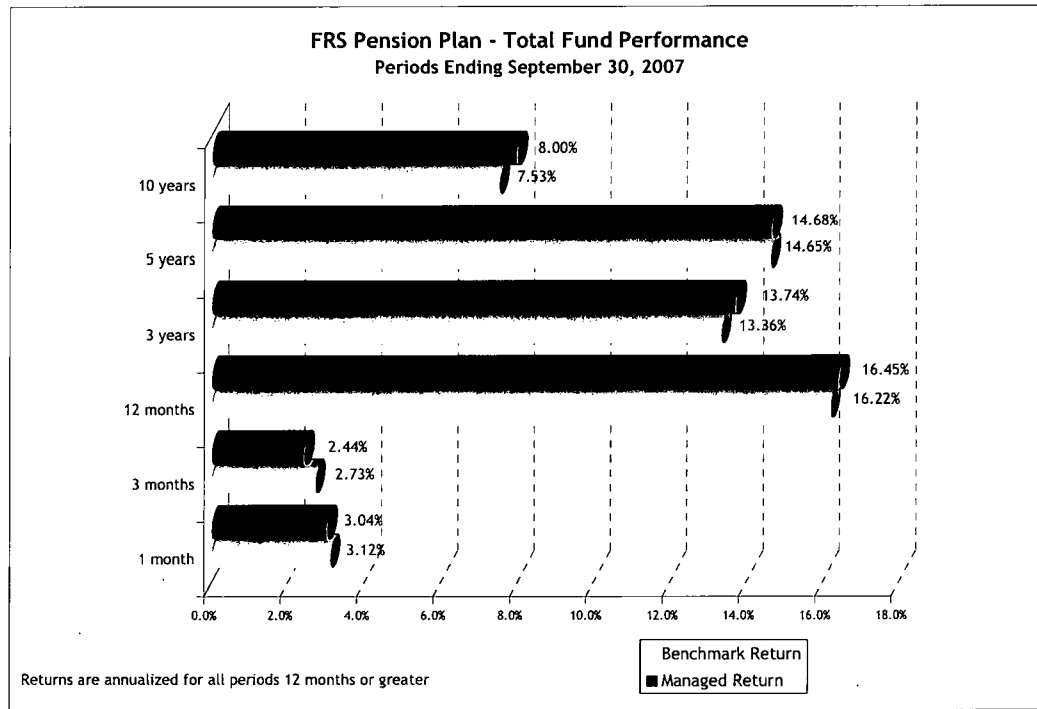


Chart 8



Importantly, Chart 9 illustrates that FRS Pension Plan performance has not been materially impacted by the recent sub-prime problems and contagion. Through September 2007, Fund performance net of fees exceeds the market benchmark for 1-year and longer measurement periods. For 1-month and 3-month periods, private market investments account for the vast majority of underperformance versus the benchmark (largely due to lags in updating property and partnership valuations heading into calendar year-end).

Chart 9



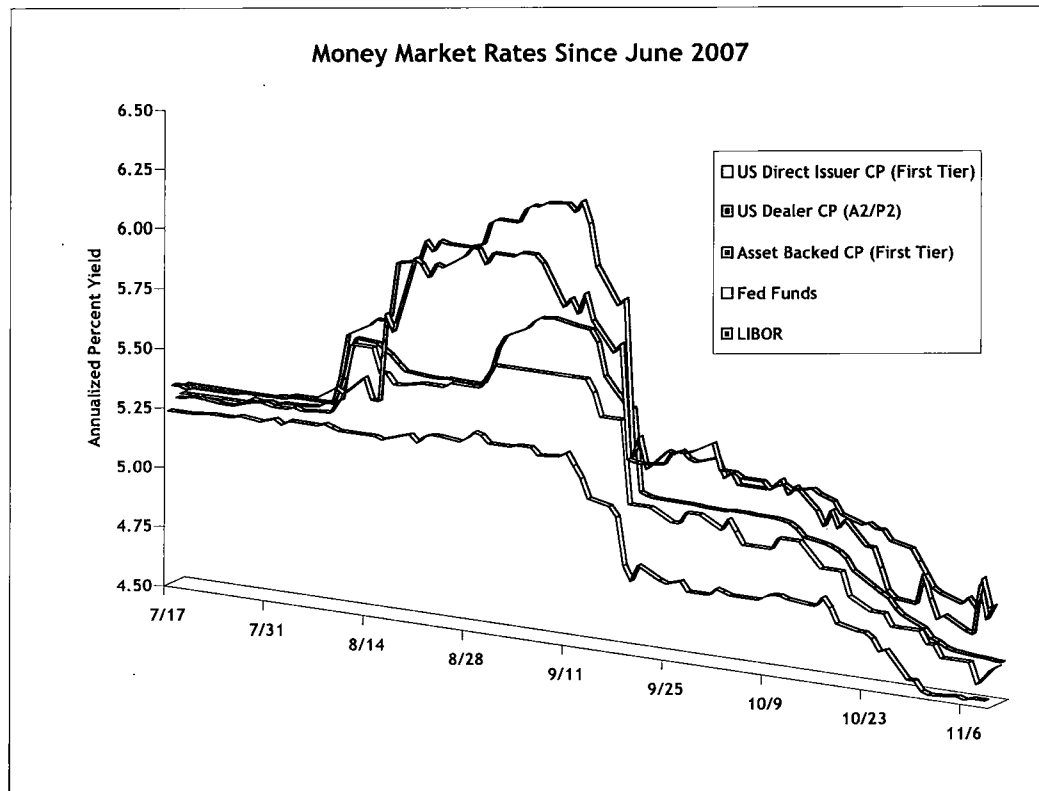
V. SBA's Short-Term Portfolios

We are pleased to report that none of the SBA's short-term portfolios (i.e., money market pools) have any direct exposure to sub-prime residential mortgages. However, in August, investor anxiety about the sub-prime issue spilled over into the commercial paper market. For many years, the SBA has purchased commercial paper with high short-term credit ratings (i.e., rated A-1/P-1 or better by Standard & Poor's and Moody's), particularly asset-backed commercial paper.

Over the last 20 years, asset-backed commercial paper has grown to constitute more than 50% of the commercial paper market. A large number of A-1+/P-1 rated commercial paper programs have been collateralized by portfolios of AAA-rated private mortgage-backed and other securities. This collateral is held in trust to protect investors in the event the commercial paper issuer defaults (hence the term asset-backed commercial paper or "ABCP"). However, these ABCP programs came under duress because of falling collateral prices and many investors' unwillingness to refinance the ABCP as it matured. Chart 10 illustrates the sharp rise in ABCP yields as issuers reacted to difficulty in finding investors.

The root cause of the market illiquidity was that AAA-rated residential mortgage-backed securities issued by private entities experienced a sharp drop in demand in August, because many of these entities were also originators of sub-prime and non-conforming residential mortgages. The mortgages supporting these AAA-rated securities typically had low delinquencies, low loan to value ratios, and high FICO scores (i.e., credit worthiness scores), but the sudden and wholesale lack of investor demand caused some prices to plummet by 5% to 10%. As a point of context, such AAA-rated residential mortgage-backed securities would typically price within a range of +/- 0.50% of par.

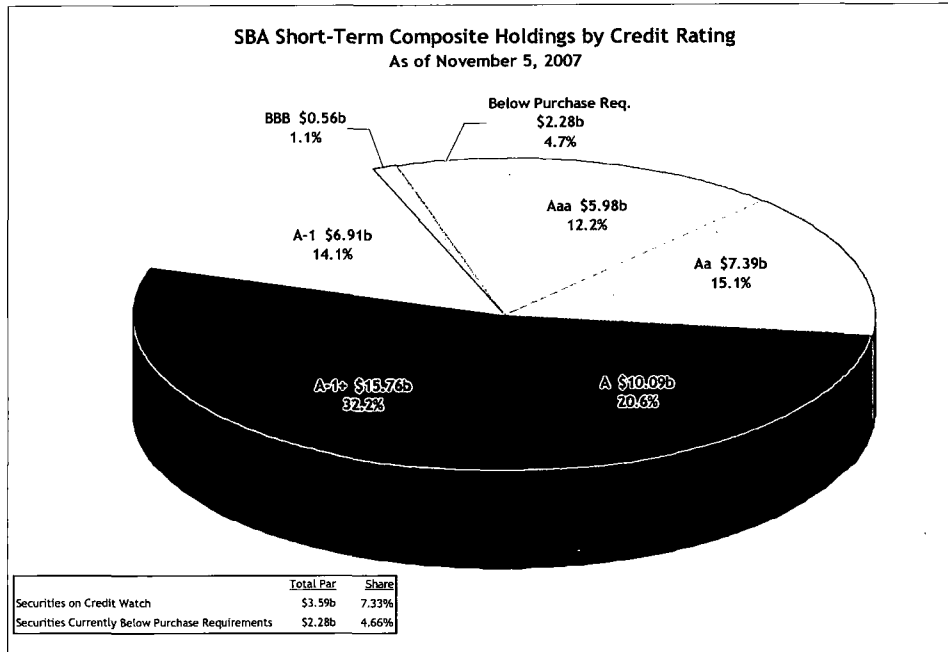
Chart 10



Overall, the SBA's short-term portfolios have maintained high credit ratings. The principal disappointment has been with downgrades of Countrywide Financial securities and several asset-backed commercial paper positions. Chart 11 illustrates the overall credit quality of a composite of all the SBA's short-term portfolios, including the amount and percentage of investments that post-purchase are now below our original stringent credit quality purchase requirements, as well as those on negative credit watch.

Additionally, we have participated in restructuring negotiations with two asset-backed commercial paper issuers to ensure that collateral is held in trust to pay principal and interest due the SBA's clients. The SBA continues to collect principal and interest on these restructured investments and has not experienced any loss.

Chart 11



Through recent months, we have continued to work diligently to ensure that all of the short-term portfolios appropriately balanced risk and return. Charts 12 and 13 demonstrate that, over various periods, the two largest short-term portfolios under the SBA's direction have delivered investment returns that track industry money market benchmarks. While financial markets are likely to remain challenging in the near future, we remain confident that these portfolios will continue to provide stable returns for participants, with an emphasis on safety and liquidity of principal.

Chart 12

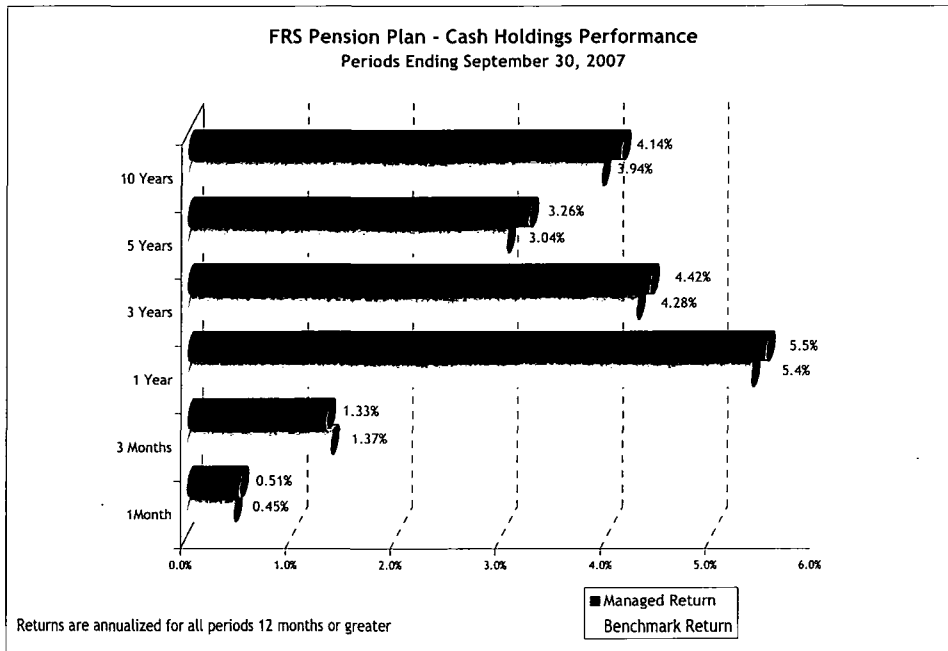
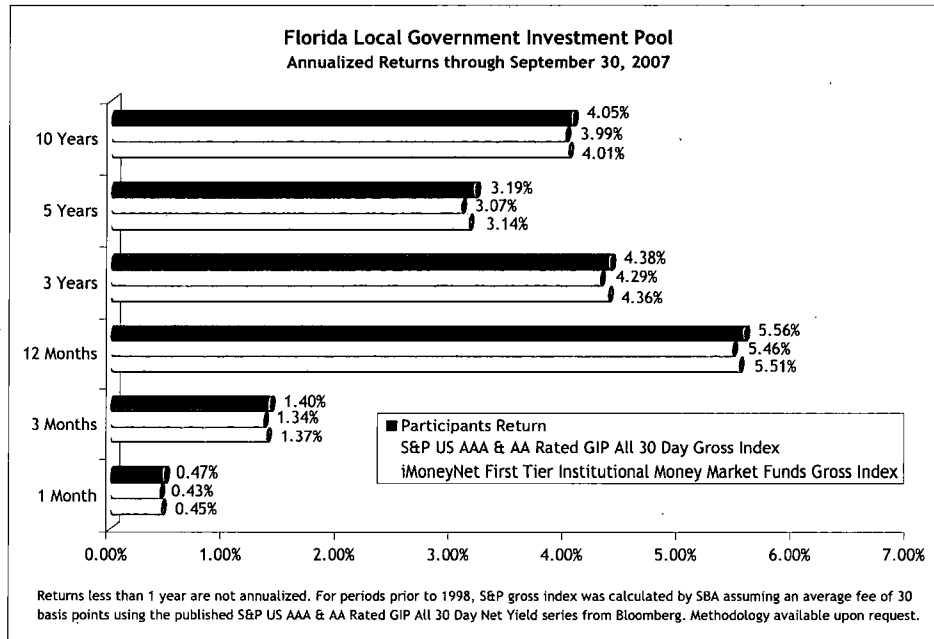


Chart 13



Nonetheless, within our short-term portfolios, we are decreasing investments in asset-backed commercial paper and financial company securities in a prudent and orderly fashion. Early this month, the SBA strategically began to reinvest asset-backed commercial paper maturities in other highly rated instruments:

1. We intend to enhance the liquidity in the SBA’s short-term portfolios because client outflows have marginally increased given heightened market uncertainty.
2. Sentiment in the money markets has been improving with two Federal Reserve interest rate cuts and injections of liquidity, but the overall environment remains somewhat unsettled with persistent anxiety regarding commercial paper credit downgrades and worries about U.S. and European commercial and investment bank sub-prime write-offs.

The SBA has also communicated a detailed update on the status of the short-term portfolios to clients. The latest quarterly Florida Local Government Investment Pool Newsletter is in the Appendix.

Downgraded Positions

Table 1 lists the current holdings that have been downgraded below the initial purchase guidelines for the various short-term portfolios.

1. KKR Pacific and KKR Atlantic (sponsored by KKR Financial Holdings) and OTTIMO (sponsored by Aladdin Capital Management) are ABCP that extended their maturities but chose to negotiate with the ABCP investors to achieve a mutually agreeable liquidation plan for the collateral. Our negotiations with KKR, alongside other senior note holders, have been completed and the interests of the ABCP investors have been protected accordingly (i.e., a capital injection by KKR, an interest rate premium, and new maturities in February/March 2008 — including an option to control the collateral at that point). The collateral supporting the Ottimo ABCP has been placed in a liquidating trust for the benefit of note holders.

2. Axon Financial is a Structured Investment Vehicle (SIV) and has just begun enforcement actions. At this point, the collateral is sufficient to pay all senior note holder maturities. The SBA has two other SIV positions (i.e., Rathgar) that have not suffered any negative rating actions.
3. There are nine Countrywide holdings of relatively small size that are primarily floating rate notes. Despite the company's setbacks and future challenges in a slow housing market, the SBA continues to expect the investments to mature as scheduled.

Chart 14: Holdings Downgraded Below the Initial Purchase Guidelines

	Maturity Date	S&P	Moody's	Fitch	Par Value	Status
Axon Financial Funding LLC	04/25/2008	A-2 *	NP	C *	\$400,000,000	Restructuring
KKR Atlantic Funding Trust	03/18/2008	A-2 *	NP	D	\$849,917,483	Restructured
KKR Pacific Funding Trust	03/18/2008	A-1 *	NP	NR	\$577,338,339	Restructured
OTTIMO Funding Ltd	03/19/2008	C *	NP	NR	\$318,859,251	Restructured
Countrywide Financial Corp	Various	BBB+ *	Baa3 *	BBB+	\$134,570,000	Expect to Mature
Countrywide Home Loans	12/19/2007	BBB+ *	Baa3 *	BBB+	\$1,450,000	Expect to Mature
Total					\$2,282,135,073	

Note: * indicates holding is on negative credit watch