



JANUARY 2008

ADVISOR

"Dedicated to Providing Retirement Security for Fire Fighters and Police Officers – Past, Present and Future."

FROM THE EXECUTIVE DIRECTOR



Warren J. Schott, CFA

I Hope everyone had a Merry Christmas and a Happy New Year. Another year has come and gone; they seem to go faster and faster each year. It has been a while since our last newsletter, so there is much to update you on.

The Pension Fund has closed its books on yet another strong year. The investment return for the fiscal year was 16.9%. The majority of this can be attributed to our large holdings in both domestic and international equities. Not to put a damper on this positive news, but these returns are just not sustainable. Our average return over the past five years is 13.8%. Our current asset allocation is structured to generate a projected average return of 8.7%. As you can see, we have substantially outperformed this benchmark, but we acknowledge that these high returns cannot continue. The Board has already taken action to reduce the risk in the portfolio by rebalancing assets away from our international equities and into a fixed income manager. Our investment Analyst, A.C. Berry will give you more detailed information regarding our investment portfolio in his article on page 2.

We have also scheduled a Strategic Planning Retreat in January to address the investment portfolio, as well as many other issues. It is important that the Board meet every couple of years to formulate a 5-year strategic plan for the Pension Fund. We will be reviewing our policies and procedures, addressing our future staffing/office needs, discussing legislative issues, receiving fiduciary training, and just brainstorming. It is a great opportunity for the Board to create goals and objectives for the staff to carry out.

We have three new Trustees on the Board. Police Lieutenant Shawn Ury was elected by the active police officers, Councilman Justin Rodriguez was appointed by the City Council, and Art Hall has been appointed by the Mayor to be his designee on the Board. Each of these individuals brings a unique set of skills to the team, and the Pension Fund is better for it. We now have trustees with experience in accounting, finance, legal, investment management and small business ownership. You are to be commended for electing such a diverse group.

Next time you come by the office, you may see some new faces. The Board has approved the hiring of an accountant and a staff attorney.

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Mark Gremmer has been serving in the role of accountant for the past seven years, but has just been promoted to Deputy Director. Congratulations Mark! Neither position has been filled, but we are in the process of posting the positions.

For all you retirees, you may notice a change in your check stub in January. Effective January 1, 2008, the Pension Fund will begin processing the retirees' payroll in-house. The City of San Antonio handled this task for us in previous years, but this did not allow us the flexibility we would like. For example, the 2006 Pension Protection Act (PPA) allows a \$3,000 tax exemption if your healthcare and long-term care premiums are deducted straight from your retirement check. Unfortunately, the City only allowed a very minimal amount of deduction codes to be used. This limitation prevented some of you from getting the full benefit of the \$3,000 tax exemption. In the coming months, the Pension Fund will be sending each of the public safety retirees a letter informing them of this new benefit. If you have a health or long-term care premium that you want deducted straight from your check, we will include a form for you to complete. Please note: widows and active members do not qualify for this \$3,000 exemption. This is only for public safety retirees. Mark Gremmer discusses this issue in more detail on page 3.

As always, if you have any questions, comments or concerns, please feel free to call me at the Pension Fund Office at 210-534-3262 or email me at wschott@swbell.net. We are here to serve you!



Annual Statements

Annual statements which include annual contributions and retirement estimates will be mailed to all active members in January 2008.

In order to insure you receive yours, we ask that your mailing address be accurate with the City of San Antonio.

Please contact your police or fire accounting departments should you need to update any information. For questions regarding the Annual Statements, please contact our Benefits Department at 210-534-3262.

For additional information on the Fund, visit us at:
www.safireandpolicepension.org

Fund Performance

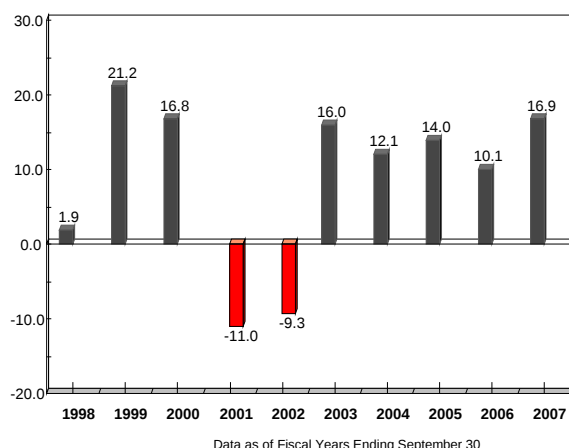
A. C. Berry, Investment Analyst



Another successful fiscal year for your Fund.....

The San Antonio Fire & Police Pension Fund (the "Fund") achieved a milestone with the closing of fiscal year 2007. For the year, the Fund realized a fiscal year return of 16.9%. This, in addition to prior fiscal year returns, produced a trailing 3-year average annual return of 13.6% and a 5-year average of 13.8%. I specifically chose 'milestone' in that your Fund was able to distribute a 13th and an unprecedented 14th check. The Board has the discretion to authorize the checks if, over the preceding 5 years, the Fund outperforms certain benchmarks. As I mentioned in previous commentaries, your fund has an *annual* target return of 8%. In accordance with Pension Law (Sections 5.11, 5.12 and 6.12), the Board has discretion to authorize a 13th and 14th check if the 5-year average return is in excess of the target by 100 basis points (9%) and 300 basis points (11%), respectively. The Fund's 5-year average return of 13.8% eclipsed both benchmarks by 480 and 280 basis points (bps), respectively.

Total Portfolio - Rate of Return
Average Rate of Return - 8.87%



But enough about the milestone, let's examine what were the key drivers in attaining a 16.9% 2007 fiscal year return. For the year, above-average performance was fairly broad-based. The equity allocation (presently comprising 33.8% of the portfolio) realized a fiscal year return of 21.6%. Domestic and international allocations both performed well on an absolute basis with returns of 16.4% and 31.2%, respectively. The fixed income allocation (21.8%) continues to show improvement and produced an asset-weighted return of 8.5%. Additionally, the Fund's alternatives continue to add value to the matrix. Alternative assets are selected as a means of further diversification away from the traditional asset classes (stock, bonds, and real estate) and their return potential. From an institutional perspective, a quick list of alternatives encompasses private equity, real assets (timber, water, infrastructure, vineyards, etc.), hedge funds, and commodities. The Fund uses the *Alternative* label when referencing its private equity and timber investments. This allocation (6.6%) realized a return of 13.1% over the fiscal year. The Fund's real estate allocation (8.5%) produced a return of 15.0% while the hedge fund composite (9.2%) realized a return of 14.0%.

These returns are quite impressive in light of the increased volatility which arose in the latter part of the fiscal year.

With regards to volatility, the San Antonio & Police Pension Fund has experienced its share of volatility during the recent turbulence. The Fund has modest exposure to the asset-backed securities (ABS) market through our portable alpha strategy. The exposure is modest (226 bps or 2.26%) in that it is exclusive to our Enhanced Cash allocation. To date, the investment has underperformed (given recent volatility) but has not experienced any defaults. Though many view the situation within the ABS market as dire, it is at the same time opportunistic. Opportunistic in that many are "throwing the baby out with the bathwater" (so to speak). That is, investors are selling securities at extreme discounts in order to meet margin requirements or raise cash. The situation is opportunistic for those willing to invest fractional amounts (of par) with the prospect of realizing appreciable gains in the future. The Fund is actively pursuing such an opportunity and I'll update you on the status at our next newsletter.

Aubrey C. Berry is Investment Analyst for the Fire and Police Pension Fund, San Antonio. Mr. Berry has over 14 years industry experience in the investment field. Mr. Berry received his B.B.A. in Finance from Incarnate Word College and M.B.A. in Finance from University of the Incarnate Word. He holds various securities licenses and is a candidate in the Chartered Financial Analyst (CFA) program.



**By: Don Wagoner,
Legislative Committee Chairman**



The 2009 Legislative process has begun and the Board and I are looking forward to working on your behalf to put together the best benefit package we can. It is a long process and, as always, we will not be able to please every member. However, there may be an opportunity to make some changes that will benefit all of us. With that in mind, the Legislative Committee would like to get as much input as possible from our members.

If you have an idea for a specific benefit that you would like the Legislative Committee to consider, please take the time to write it down and forward it to one of your trustees by March 7, 2008, or to the Fund staff at: www.safireandpolicepension.org. The Committee will be meeting with representatives from the Fire Association, Police Association and the Retiree's Association. The Committee will also meet with the City of San Antonio for their input.

As you can see, we try to get as much input as possible from everyone concerned. This is a process that has been developed over the past several years, and has been very successful. **So put your mind to work and let us hear from you!**

MEMBER BENEFITS...

Mark Gremmer, Deputy Director



ATTENTION: Retired Public Safety Officers – As we start the New Year, thoughts of preparing our tax returns start to fill our heads. We start anxiously awaiting the 1040 package from the IRS and our W-2s and 1099s from those who have paid us wages or retirement benefits or other types of taxable income. Once we have it all together, we can start to fill out the forms to see whether we have a refund or the other alternative.

Everyone's situation is a little different, but this year there is something new that retired Public Safety Officers should be aware of. The Pension Protection Act (PPA) of 2006 allows for the exclusion from taxable income of up to \$3,000 for premiums paid for health insurance, accident insurance and long-term care insurance.

What you need to know is that the 1099-R that you receive from the City will NOT show how much was paid for health insurance. You will have to get that information from your own records. Your last check stub for 2007 should have that information on it. You should save that check stub for tax purposes. The instruction booklets that come with the Form 1040 and Form 1040A have instructions for putting this information on your return. The following is an excerpt from the Form 1040 instructions:

"INSURANCE PREMIUMS FOR RETIRED PUBLIC SAFETY OFFICERS

If you are an eligible retired public safety officer (law enforcement officer, firefighter, chaplain, or member of a rescue squad or ambulance crew), you can elect to exclude from income distributions made from your eligible retirement plan that are used to pay the premiums for accident or health insurance or long-term care insurance. The premiums can be for coverage for you, your spouse, or dependents. The distribution must be made directly from the plan to the insurance provider. You can exclude from income the smaller of the amount of the insurance premiums or \$3,000. You can only make this election for amounts that would otherwise be included in your income.

An eligible retirement plan is a governmental plan that is:

- a qualified trust,
- a section 403(a) plan,
- a section 403(b) annuity, or
- a section 457(b) plan.

If you make this election, reduce the otherwise taxable amount of your pension or annuity by the amount excluded. The amount shown in box 2a of Form 1099-R does not reflect the exclusion. Report your total distributions on 16a and the taxable amount on 16b. Enter "PSO" next to line 16b."

(Those filing Form 1040A would substitute lines 12a and 12b for lines 16a and 16b.)

ATTENTION: Public Safety Officers retiring after January 1, 2007 – Again, due to the PPA, Public Safety Officers who retire in the year they turn 50 or after will not be subject to the 10% penalty charged for premature distributions if they take that distribution directly from the Pension Fund. It is still taxable income, though (just not a penalty).

If the distribution is rolled over into an IRA or a 457 plan (see exception below) or other qualified plan, it cannot be withdrawn as a lump sum until the retiree reaches 59 ½ without being subject to the penalty, if no other exception applies. The important date is when you RETIRE, not when you RECEIVE the distribution. So you have to turn 50 in the calendar year that you retire in order for this exception to apply. (See the examples below.) EXCEPTION: There is still an exception regarding distributions rolled over into a 457 plan. If you retire in the year you reach 55 years of age or older, your backDROP can be rolled over to a 457 plan and can then be withdrawn from the 457 plan without incurring a penalty. This option is NOT available if your age is less than 55 years on December 31 of the year you retire even if you do roll it over into a 457 plan.

Example 1: John's birthday is February 3, 1957. John retires January 31, 2007 and receives his backDROP directly on February 28, 2007. The exception applies, and John's backDROP is not subject to the 10% penalty, because John reaches the age of 50 the same calendar year in which he retires, which is the year ended December 31, 2007.

Example 2: John's birthday is still February 3, 1957, but he retires on December 31, 2006. John still does not receive his direct backDROP until February 28, 2007, but the exception DOES NOT apply, and the backDROP is subject to the 10% penalty. John was 49 in the year he retired even though he did not receive his distribution until the year he turned 50.

IMPORTANT NOTE: This article is not intended to be considered tax advice and should NOT be relied upon for determining your particular tax situation. Be sure to check with your professional tax advisor prior to making any decisions about your course of action.

As we plan for the future, the staff at the Pension Fund has two large projects to undertake in 2008. First, we will be preparing the retiree payroll in-house this year. As you know, in the past, the City has done the actual processing of the payroll, including all of the tax reporting. This year, beginning with the first payroll in January, the staff at the Pension Fund will process the payroll without the help of the City. To be sure, this is a good time to say that we are very grateful to the payroll and ERP departments at the City for all of the help they have provided in the past. They have always taken very good care of us. Because of some of the issues brought about by the Pension Protection Act of 2006, we feel that now is a good time to start processing payroll in-house. This will allow us to tailor our service more specifically to our retired members since they are the focus of our payroll function.

Staff is also in the process of upgrading our Pension Administration Software that is used for member recordkeeping. We have been using the same software since 1995. As you can probably imagine, we are going to be very busy during this process. In the long run, however, the new software will help our staff become more efficient in addition to keeping us current with the new technology.

January is also the month that retirees receive their Cost of Living Adjustment (COLA). In accordance with the Pension Law which became effective October 1, 2007, we will be applying the full COLA, subject to the 8% limitation, to those members who retired prior to October 1, 1997. Retirements after that date will receive 75% of the COLA. As this article is being written, the Bureau of Labor and Statistics has not released its calculated amount for the Consumer Price Index for all Urban Consumers for December 31, 2007, which is the rate we use. Please keep your eyes open for the adjustment on your January retirement check.

A Primer on Subprime.....

A. C. Berry, Investment Analyst

During the latter half of the summer, problems in mortgage-backed assets (MBS) spilled over into other asset classes and by degree, the economy as a whole. One cannot pick up a newspaper or listen to the news without some comment about subprime mortgages and how they are impacting housing and stock markets. For greater clarity on why volatility has increased, let's examine non-prime rate mortgages, their place in the aggregate mortgage universe, foreclosure rates, and how problems in the subprime mortgage led to the credit crunch. First, let's define types of alternative mortgages versus prime rate lending. A subprime loan is typically used by borrowers that have lower credit scores, a history of delinquencies, or have even filed for bankruptcy. Terms of these loans tend to be less favorable than prime rate loans with higher interest rates and other fees to compensate lenders for the increased risk of default. Alt-A or alternative documentation loans also demand higher interest rates when the required documentation is unavailable. The borrower may have volatile sources of income, prefer not to disclose their sources of income, or is unable to document enough income to qualify for a loan. Next, let's examine the composition of the aggregate mortgage universe to better understand the far-reaching effects of the subprime dilemma. As illustrated below, subprime loans represent a fairly small part of the overall mortgage market. But their foreclosure rate exceeds 50% (of all loans outstanding) when subprime fixed rate and adjustable rate mortgages (ARMs) are combined together.

Source: Mortgage Bankers Association	Percent of Outstanding Loans	Percent of Foreclosures Started
Prime Fixed	63.1%	17.6%
Prime ARM	14.5%	18.7%
Subprime Fixed	6.3%	12.0%
Subprime ARM	6.8%	43.0%
FHA & VA	9.3%	8.7%

Data as of September 30, 2007

By the end of the third quarter, the percent of loans in the foreclosure process stood at 1.69 percent of all loans outstanding, an increase of 29 bps from the second quarter and 64 bps from one year ago. Delinquency rates also rose. The delinquency rate for mortgage loans on one-to-four unit residential properties stood at 5.59 percent of all loans outstanding in the third quarter. The rate was 47 bps higher than the second quarter of the year and 92 bps over a year ago. Though the numbers support a deteriorating real estate market, key drivers in the erosion are California, Florida, Ohio, Michigan, and Indiana. Consider a statement from the Mortgage Bankers Association report: "Florida and California are the two largest states in terms

of mortgages outstanding and are the key drivers of the increase in the national foreclosure rates. While California and Florida together have 36.4 percent of all the prime ARM loans in the country, they had 42.4 percent of the nation's foreclosure starts for prime ARMs. Similarly, California and Florida together have 28.1 percent of the subprime ARMs and 33.7 percent of foreclosure starts for subprime ARMs. Florida, Ohio, Michigan and Indiana have 16.4 percent of the fixed prime rate loans in the country but 29.3% of the foreclosures started on prime fixed loans, and 18.9 percent of the subprime fixed rate loans and 26.3 percent of the foreclosure starts". Another report provided by Inside Mortgage Finance, stated that subprime mortgages accounted for 20% of all mortgage originated in 2006. Additionally, \$2.3 trillion of subprime loans were taken out by borrowers in the period between 2002 and 2006. Growth was attributed to the ability of lenders to spread the risks by packaging the loans into securities and selling them to a large number of investors from pension funds to hedge funds, who used the various rating agencies (S&P, Moody's, Fitch) to help gauge the quality of the bonds.

While it's true that the subprime mortgage problem is the center of all the turbulence, it's important to reflect upon how the problem evolved to be so far reaching. Not long ago, banks sought to divest themselves of risky assets on their balance sheet. The divestment came in the form of securitizing the assets with the assistance of investment bankers. Securitizing was accomplished through asset-backed securities (ABS) which was further repackaged into structured products, such as collateralized debt obligations (CDOs) and collateralized loan obligations (CLOs). These structured products were then sold by investment bankers to the far-reaching global investor looking for higher yields. Structured products typically offer significantly higher yields relative to traditional securities with equivalent credit ratings. Higher yields were attained through embedded leverage within the structured product. With spreads (relative to Treasury bonds) near historical lows, flattening yield curves, and low-yield alternatives in countries outside the United States, investors were attracted to the relatively higher yields that structured products offered. The same perspective was taken by banks, thanks in part to new regulations which encouraged banks to purchase assets with higher credit ratings (as a means of reducing their capital requirement).

The credit markets turn vicious.....

With increased demand for return, yield spreads over LIBOR (London Interbank Offer Rate) for asset-backed securities approached historically tight levels in January 2007. Pricing for stronger quality home securities were based on a best-case scenario of home price appreciation, falling mortgage and financing rates, and a robust economy. Lower quality credits had comparable pricing assumptions given an insatiable appetite for yield by the markets. The environment did subsequently change when home price appreciation declined and delinquencies for subprime loans accelerated. Eventually, losses in subprime mortgages occurred as home price appreciation slowed and artificially low 'teaser' rates were replaced by higher market based rates. From subprime loans, fear spread into the leveraged loan market. These loans were used to support collateralized loan obligations (CLOs) which were predominantly in favor over high yield debt issuance (by a factor of 3 to 1) in early 2007. Asset-backed commercial paper (ABCP) conduits were stressed as a result of structured investment vehicles (SIV) inability to meet a series of capital and liquidity tests. The failure was a direct result of investor's refusal to purchase commercial paper issued by these vehicles. [*\(Continues on Page 5\)*](#)

A Primer on Subprime (Cont.)

This rendered an inability to rollover existing commercial paper, forcing immense liquidations. By August, the rating agencies downgraded over \$35B in subprime asset-backed deals and placed a remaining portion of the outstanding debt on review. The downgrade, coupled with concerns of margin collateral on leveraged assets led to a complete reevaluation of asset levels and deterioration in investor confidence. Many leveraged players were forced to sell securities to meet margin requirements, prompting sales driven by risk aversion. A sharp elevation in volatility caused increase margin requirements on these types of leveraged assets. This in turn fed a downward spiral of mark-to-market pricing challenges, coupled with forces liquidations. Fresh with the fear of further rating agency downgrades, investors were forced to find assets to hedge their positions or raise cash as collateral. Short-term lending rates were stressed to such a degree that money center banks began to suffer the effects and forced to take action. This led central banks from around the world to inject funds as a means of curbing the increase in overnight lending rates. The Federal Reserve subsequently moved to lower both the fed funds and discount rate as a means of curbing tightening liquidity.

The outlook ahead.....

Market fundamentals are likely to get worse before they get better. Many expect the fourth quarter to mark the beginning of an extended economic slowdown as falling home prices and tighter credit reign in growth. A recent report shows U.S. home prices fell in October for the 10th consecutive month, posting their largest drop since early 1991. The record 6.7 percent drop in the Standard & Poor's/Case-Shiller home price index also marked the 23rd consecutive month that prices either fell or grew more slowly than in the previous month. As home inventory climbs, the end of the housing recession moves further into the future. This increases the likelihood of significant collateral damage on consumer consumption. Falling home values will likely slow growth in wealth and consumption. Additionally, the consumer has been hit by rising energy prices and tighter credit, which coupled with the housing slump, is starting to weigh on confidence. Consumer spending is likely slow, thereby lowering gross domestic product (GDP) below trend (<3.5%). Amid all the turmoil, there are both challenges and opportunities for the investment community.

In Memoriam

As this is the first newsletter of the New Year, we would like to take this opportunity to honor the memory of those active and retired police officers and fire fighters who passed away in 2007. We will continue to be grateful for their past service and sacrifice.

Police

William I. Potts	January 10, 2007
Manuel Hernandez	January 20, 2007
Arthur H. Bonnet	April 13, 2007
Rudolph Fuentes	April 21, 2007
Melvin D. Wondra	June 27, 2007
James E. Despres	July 15, 2007
Mario Moreno	September 21, 2007
William F. Davis	September 22, 2007
Manuel G. Martinez	September 23, 2007
Martha B. Schnabel	October 9, 2007
John Russell Bocko	November 2, 2007
Richard F. Stengel	November 5, 2007
Frank Castillon	November 6, 2007
Gene R. Danish	November 21, 2007
Darrell L. Pleasant	November 26, 2007

Fire Fighters

Alex Vidal, Sr.	February 27, 2007
Anthony Pedrotti	February 28, 2007
Pedro Charles Corrales	March 29, 2007
Roland Zoeller	June 14, 2007
Eugene C. Greenwood, Jr.	July 30, 2007
Alex S. Crank	September 24, 2007

July 2007 – December 2007 Retirees

July 2007 – Police

Adelbert P. Reyes – 21 years

August 2007 - Fire

Robert H. Vargas – 33 years

August 2007 - Police

Kenneth G. Philips – 33 years

September 2007 - Police

Timothy Rupp – 23 years

Christine L. Steiber – 22 years

October 2007 - Fire

Joe A Benavides – 32 years

Alan E. Boozikee – 33 years

David A. Covington – 32 years

Garland R. Harms – 31 years

Michael H. Trevino – 31 years

Jose L. Alanis – 33 years

John Anderson, Jr. – 31 years

Roy V. Casanova, Jr. – 31 years

October 2007 – Fire (Cont.)

Ruben A. Cevallos – 32 years

Ralph Sifuentes – 31 years

Calvin T. Smith – 23 years

Bruce R. Moore – 32 years

Gilbert C. Villareal – 31 years

James O. Hill- 30 years

Jesus Sanchez, Jr. – 37 years

October 2007 – Police

Lawrence W. Roberts – 33 years

Frank W. Janicke – 33 years

Samuel E. Moore – 33 years

November 2007 – Fire

Richard D. Bueno – 32 years

David M. Cavazos – 32 years

Hector Garcia – 30 years

Charles H. Sutherlun – 32 years

Ruben E. Ramon – 27 years

Michael Reidenbach – 30 years

Louis L. Delgado – 34 years

November 2007 - Police

David G. Evans – 28 years

December 2007 – Fire

James Momone, Jr. – 30 years



January – June 2007 Retirees were honored in our July newsletter.



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