

AN INVESTMENT MANAGEMENT PROPOSAL  
FOR  
WORLDWIDE INDUSTRIES'  
EMPLOYEE PENSION PLAN  
PREPARED BY  
ATLAS INVESTMENT ADVISORS



## ***Table of Contents***

<b><i>Introduction</i></b> .....	<b>3</b>
<b><i>Investment Philosophy</i></b> .....	<b>4</b>
<b><i>Baseline Forecasts</i></b> .....	<b>5</b>
<b><i>Baseline Forecasts - Rationale and Risks</i></b> .....	<b>5</b>
<b><i>GDP Growth</i></b> .....	<b>5</b>
<b><i>Inflation and Interest Rates</i></b> .....	<b>7</b>
<b><i>Currency Exchange Rates</i></b> .....	<b>8</b>
<b><i>Topical Q&amp;A</i></b> .....	<b>8</b>
<b><i>Investment Policy Development – Risks and Opportunities</i></b> .....	<b>12</b>
<b><i>Recommended Strategic Investment Policy</i></b> .....	<b>12</b>
<b><i>Recommended Tactical Investment Policy</i></b> .....	<b>13</b>
<b><i>Risks and Opportunities</i></b> .....	<b>14</b>
<b><i>Risk, Return, and Worldwide Industries’ Pension Obligations</i></b> .....	<b>16</b>
<b><i>Statement to the Employees of Worldwide Industries</i></b> .....	<b>16</b>

Note: To jump to a particular section of the presentation, hold down the CTRL key and click on the page number.

## Introduction

Pension plans must be managed with regard to the liabilities they support. The reason is that the risk implied by a specific pension investment policy can interplay with the normal operating risk of the company. For example, if a plan manager experiences low pension investment returns that coincide with a period of low operational profitability, the pension plan may require additional cash contributions at a time when corporate cash flows are already at an uncomfortable level. Therefore, decisions on pension fund asset allocation can have a pivotal effect on Worldwide's financial well-being.

Worldwide Industries has explicitly recognized the obligation to stand behind its pension liabilities and fulfill its fiduciary responsibilities. A significant part of fulfilling Worldwide's fiduciary responsibilities regarding the management of its employee pension fund is to develop a multi-step process that encompasses the entire investment management function. The following five steps are integral components of all prudent pension investment policies:

1. Determine a long-term investment policy weighted component index that reflects the aggregate investment in very broad asset classes (e.g. 65% equities/35% bonds). This benchmark is developed in concert with actuarial projections of pension fund liabilities over various time frames. This benchmark is in effect the default investment policy and should not change much, if any, over time.
2. Specify a strategic investment policy weighted component index that identifies unique individual components (e.g. U.S. equities, International equities, Real Estate). The weights of the components are determined by estimating long-term returns to the individual component asset classes, as well as their respective risk and correlation attributes. In addition, strict parameters are established that are designed to constrain the investment manager from deviating too far from the strategic benchmark when implementing their tactical investment views.
3. Fine-tune the strategic policy component weights by taking active, opportunistic positions versus the strategic benchmark. This is accomplished by implementing a tactical policy benchmark. The tactical policy benchmark is designed to capture the investment manager's shorter-term views on expected risk and return for the various asset classes. Unlike the long-term and strategic policy benchmarks, the tactical policy benchmark should be expected to change slowly and steadily over time.
4. Performance attribution and review is reported on a monthly, quarterly, and yearly basis. This step is designed to verify that the investment manager is adhering to the broad strategic investment policy guidelines established in Step 2 above. Performance review is also a vital step in measuring an investment manager's ability to add-value through their tactical investment views.
5. Results from the performance review are fed back into Step 3 in an iterative fashion. This step is usually implemented on an annual basis.

## **Investment Philosophy**

Atlas Investment Advisors' (AIA) investment philosophy derives from extensive empirical research indicating that 90% of the realized total risk in pension fund investment returns is attributable to asset allocation decisions made by a pension's board. The research highlights the importance of the first two steps in the investment management process, while also pointing to the source of sub-par investment performance realized by Worldwide's pension fund.

Choosing pension managers that place considerable tactical bets versus an established strategic benchmark introduces an unwarranted amount of risk in the form of potential shortfall of investment returns to meet expected future pension liabilities. The most prudent course of action is to establish long-term and strategic policy benchmarks with relatively constrained component weights. Therefore, the tactical views implemented by the investment manager will have a limited impact on the expected excess (deficit) return from implementing these views, taking into consideration the added risk implied by deviating from the strategic benchmark.

Diversification amongst various asset classes is the key to efficiently managing the risk/return trade-off. The overall goal is to maximize the level of expected return per unit of investment risk. The unit of investment risk commonly chosen is the standard deviation of expected returns. Diversification benefits are derived from the fact that broad investment classes (e.g. stocks, bonds) are less than perfectly correlated.

We believe that diversification benefits can be most fully realized by establishing a long-term strategic benchmark that includes international asset classes, in addition to U.S. equities, bonds and real estate. Three reasons underpin our contention that global diversification is the most efficient way to optimize the risk/return trade-off:

1. Global versus purely domestic investing broadens investment opportunity by expanding the set of risk/return choices. More risk/return choice increases the probability of meeting long-term performance goals.
2. International investing provides for risk diversification, because most international markets have a low or moderate correlation with their U.S. counterparts.
3. The absolute returns generated by non-U.S. securities often have substantially exceeded those for U.S. securities. These superior results often persist when returns are adjusted for risk.

In the sections that follow, we will address specific topics of concern to Worldwide. Specifically, we will discuss historical and expected returns for various asset classes, risks associated with our forecasts, and the establishment of a long-term strategic benchmark. We will then use the established investment policy as a guide to form expectations regarding investment return and the fulfillment of pension fund liabilities.

## Baseline Forecasts

First, we recognize Worldwide's desire to earn a real return of 7-8% per annum. We assume this return will fully fund Worldwide's pension liability. In order to develop a context in which to discuss expected returns, we also assume the following six broad asset categories are to be included in the strategic policy benchmark: U.S. Government bonds, U.S. equities, Japanese equities, European and Oceanic equities, Emerging Market equities, and U.S. real estate. We realize that Worldwide is also interested in International Bonds, and we will discuss their inclusion in the model below.

Per Worldwide's request, we provide the following table of forecast assumptions which will be used to derive the pension fund's expected return:

	Real GDP Growth	CPI Inflation	3-month Yields	10-year Govt. Yields	Key Equity Market Returns	US\$ Exchange Rates
U.S.	2.75%	2.25%	1.50%	4.50%	6.5%	
Euro Zone	1.00%	1.75%	2.25%	4.00%	6.00%	1.12 €/\$
Japan	0.50%	-.25%	0.00%	1.00%	5.50%	118 \$/¥

*Table 1 – Key Forecast Input Parameters*

## Baseline Forecasts - Rationale and Risks

### *GDP Growth*

We start the discussion of GDP growth prospects by noting that the U.S. continues to be the economic engine that drives global growth. In the face of a burst stock market bubble, terrorist attacks, corporate scandal, and outright war, the U.S. has managed to not only pull itself out of a recent recession, but also to post decent real GDP growth, all things considered. We attribute the ability of the U.S. to recover in a relatively short time span to the economic and financial flexibility of the system. The U.S. possesses a highly skilled, productive and mobile work force. The current unemployment rate of 5.8%, while high relative to the low of the last business cycle (about 4.2%), was at one time considered nearly full employment.

The U.S. financial system is in excellent condition. Commercial banks have maintained consistently high profits and returns on assets through their efforts to contain costs, to increase their sources of non-interest income (e.g. fee income), and to maintain high standards of credit quality. Loan-loss performance has improved steadily, because banks have learned how to manage credit risks better by making much greater use of secondary loan markets, and derivative instruments such as credit default swaps. Asset growth remains solid, and with high levels of capital, most banks seem willing and able to lend, a situation much different from the period following the 1990-91 recession. However, this leads us to a discussion of what we consider the two greatest risks to continued economic

recovery; a recovery in business fixed investment, and continued consumer spending growth.

The increases in productivity we have seen in the non-farm business sector over the past two years have been truly remarkable, particularly in light of the fact that productivity growth is typically weak during recessions. Clearly, business managers have dedicated themselves to producing more with less and to raising profits by cutting costs. However, the U.S. is currently running at only 75% capacity utilization. There is considerable overcapacity in a number of sectors, notably the telecommunications sector. Corporate profitability is weak, pensions in aggregate are under-funded, and corporate bond yield spreads, while having recently recovered, are still as high as they were during the 1990-91 recession. In addition, the high level of uncertainty associated with war in Iraq, a nuclear North Korea, and the ongoing war on terrorism, have introduced large levels of uncertainty into business plans. Consensus forecast of improvement in business fixed investment is clearly at risk. So while the financial sector is fully capable of extending credit to spur business investment, business demand for credit remains tepid.

The second major growth risk factor is centered on consumer spending growth. Consumer expenditures account for over two-thirds of nominal GDP growth. Strong consumer spending not only helped cushion a sharp and painful economic contraction; it also was instrumental in supporting the early stages of the recovery. Real disposable income continued to grow throughout the recession, bolstered by tax cuts and record home mortgage refinancing. In addition, the negative wealth effect from the bursting of the stock market bubble has probably run its course. We believe the risk to continued consumer spending growth lies with two sources; a failure of businesses to expand, and a serious fall-off in consumer confidence.

We have mentioned the risks to the business sector. Consumer confidence has fallen significantly in the last several months. This is reflected in improving household savings rates, and the recent drop-off in discretionary purchases (e.g. autos, dishwashers). Our greatest concern is a scenario where consumer spending growth contracts due to another terrorist attack, escalating tensions with North Korea, or an Iraq war that drags on for a couple of quarters. A fall-off in consumer spending could further damage corporate profitability, leading to further lay-offs, which would ultimately lead to another recession. We place an estimated chance of one-in-five that such a scenario could unfold.

We would also like to highlight some of the risks associated with our GDP growth forecasts for Japan, as well as the Euro Zone region. First, we discuss Japan.

Japan's economy remains structurally challenged. Economic activity is stagnant. Exports and manufacturing, typical growth drivers, show no signs of secular improvement. Private consumption is likely to remain weak, due to record high levels of unemployment and stagnating real income growth. Japan's financial system currently lies at the heart of their troubles. Non-performing loans, once characterized as the result of fallout of a burst real estate and stock market bubble, have since been recognized as a problem of recently funded business loans. On the demand for funds side of the coin, corporations continue to struggle under a massive debt burden. Basically, the financial intermediation function in Japan has broken down.

The Japanese government and monetary authorities have injected enormous stimulus into the economy, but since the problem is not cyclical in nature, the impact has been limited. In addition, Japan's labor market is inflexible, and demographics place Japan's average age of a typical worker the highest in the developed world. We note some nascent signs of reform, namely a new head of the Bank of Japan, and some banking reform. However, until we detect serious reform, unfortunately in the form of large bank failures, accelerated pace of layoffs, and continued capital market reform to open the system, we remain skeptical of any new signs of growth.

Unfortunately, the overall picture in the Euro Zone is also one of stagnation. While officials blame uncertain growth conditions in the U.S. and war in Iraq, most market analysts concede that Europe's economic woes are homegrown. We concur with the latter assessment. We recognize Europe's success in launching the first steps towards monetary union with the introduction of the Euro, as well as the establishment of the Stability and Growth Pact, which is designed to coordinate fiscal policies across the EU. However, one official recently noted that the Pact is acting like a straight jacket, as it severely limits the ability of any one government to use fiscal stimulus. He warned that the lack of flexibility from a fiscal point of view could lead to a Japanese style deflation.

We place greater emphasis on necessary labor market reform, coupled with a more highly integrated financial market, as the most urgent obstacles preventing renewed growth. The sustainability of generous pension systems, wage settlements in Germany that continue to constrain flexibility and are out of line with low productivity growth, and a true lack of political will à la Margaret Thatcher's reform efforts in Great Britain during the late 1970's and early 1980's are the most serious issues facing Europe. Expensive labor relative to productivity and a strengthening currency could make it very difficult for European companies to compete in an increasingly global market place.

### ***Inflation and Interest Rates***

Inflation exists in specific commodity markets (e.g. oil, gold), specific economic sectors (e.g. healthcare), and in certain regions of the world (e.g. Brazil). However, general inflation is not a problem in the developed economies of the U.S., Europe, Japan, and Asia. In fact, deflation is a serious policy challenge for most of Asia. Starting with burst financial and real asset bubbles in Japan, and continuing with a high-tech industry slowdown in the U.S. and the admittance of China into the World Trade Organization, prices of goods have come under relentless pressure. We note the serious industrial challenge China poses for Japan, Taiwan, Korea and Singapore. Direct investment into mainland China is already beginning to hollow-out the manufacturing bases of Taiwan and Japan. Taiwan has been able to shift its focus to service-oriented industry, and Korea has made great progress liberalizing its financial and labor markets. However, relative inflexibility in Japan is exacerbating an already grim economic situation. We believe China will continue to be a global deflationary force for decades.

European inflation has been higher than expected, particularly in light of stagnant economic growth. This is due to lack of progress on labor market reform. Therefore, the European Central Bank has not been as aggressive in lowering interest rates as most analysts had hoped. We believe rates will continue downward over the near to medium

term, but temper our forecast by noting statements made by senior ECB officials suggesting that monetary policy has nearly accomplished what it set out to do, and that it is up to politicians and fiscal authorities to effect the necessary changes that will relieve inflationary pressures and spur economic growth.

In summary, we believe the risks to our growth forecasts for the U.S., Europe, and Japan are marginally to the downside. Accordingly, our forecast for interest rates is lower than the consensus view of year-end rates. We believe the average price of oil will be lower this year, healthcare cost increases will moderate, and consumer expenditures will level off. While it is true that monetary policy has been extraordinarily accommodative, we do not see that fact alone as justification that interest rates should rise significantly by year-end. Uncertainty generated by the Iraq war, very low levels of capacity utilization, and disinflationary pressures from China, all place short upper bounds on inflation. Until capacity utilization moves up strongly, industrial production recovers in a sustained fashion, unemployment moves down, and consumer confidence rebounds, we are unlikely to see a more restrictive policy from the Federal Reserve.

### ***Currency Exchange Rates***

Renewed U.S. Government budget deficits and record current account deficits drive our currency forecasts. We believe the U.S. dollar will continue to weaken, most notably against the Euro, and to a lesser extent, the Japanese Yen. In particular, the current account balance will force the U.S. dollar to depreciate. The U.S. does not save enough to internally fund its capital and consumption requirements. Therefore, the U.S. needs outside capital, in the form of stock and bond purchases, as well as direct investment, to balance the financial account with the current account.

Although many analysts blame the American consumer's penchant to consume rather than save as the source of the current account deficit, we note that the responsiveness of imports to income is much greater in the U.S. than the rest of the world. The growth of the U.S. financial account in 2002 nearly offset the growth in the current account deficit. The deciding factor leading to depreciation of the U.S. dollar can be traced to a sharp fall-off in net direct foreign investment. We expect these trends to continue, but note that the U.S. dollar would likely stabilize and strengthen if corporate activity and the stock market recover.

### **Topical Q&A**

We have touched on many of the issues of greatest interest to Worldwide in the previous sections. We would like to continue the discussion of those issues employing a question and answer format.

**Q:** Can the U.S. economy re-attain its pre-recession pattern of rapid GDP growth and low inflation assuming the war issue is solved quickly?

**A:** Quick resolution of the conflict in Iraq, as well as the alleviation of the growing tensions on the Korean Peninsula, would remove a significant level of uncertainty from

business plans and consumer spending. Our base case scenario calls for flat, but sustained, GDP growth, as well as historically moderate levels of inflation. We do not expect the U.S. to immediately attain higher levels of growth until mid to late 2004. The main obstacle to robust economic growth is the lack of growth in business fixed investment. Capacity utilization in the U.S. sits at only 75%. Trends in globalization will continue to force U.S. manufacturers to shift production overseas, so even if economic activity gains traction, the response to business investment may be muted. Productivity growth remains solid, and assuming unemployment has peaked for this cycle, growth in disposable income should support a normal level of real GDP growth of 3.5% over the long run. Inflation likewise should remain muted, and we expect headline CPI to remain under 3% for the next couple of years.

**Q:** Have the events of September 11 and the ongoing anti-terrorist campaign changed your long-term view of the U.S. economy and the attractiveness of investing in U.S. financial markets?

**A:** The U.S. economy possesses the most structural integrity and flexibility of any economy in the world. We do not believe a long-term anti-terrorist campaign will prevent our economy from returning to normal trend performance levels. While the U.S. stock market (as measured by the S&P 500) continues to trade at relatively high valuation levels, we believe that earnings growth should support a nominal long-term total return of around 8 - 9%. Resource allocation may not be as optimal as it might be without the diversion of activity away from normal economic functions to defense-related investment. Nonetheless, we have not changed our views on the long-run attractiveness of investing in the U.S.

**Q:** How will the U.S. economy and financial markets be impacted by the deepening saga of corporate accounting irregularities and financial disclosure problems?

**A:** The stability and strength of U.S. financial markets depend critically on confidence; confidence in fair dealing, confidence in the honoring of contracts, and confidence that one can, given adequate disclosure, ascertain risk/return tradeoffs for various investment opportunities. We believe that the recent corporate scandals that have splashed headlines around the world have damaged the credibility of a number of market participants, and shaken investors' trust that the system functions fairly. We also believe that this is a great opportunity for politicians and regulators to change the incentives that underpin much of the corporate malfeasance. Adding regulations and extra layers of bureaucratic bloat are not the answer. Rather, clarification of the accounting treatment of options, refining the disclosure guidelines on special purpose entities, and incentive-based reform such as the elimination of the double taxation of dividends (by eliminating the corporate income tax), would create an environment in which investors could feel confident. We believe many of these changes are now under way, and consider the worst offenses behind us.

**Q:** Do you think the U.S. federal budget surplus will be restored during this decade? If not, what are the implications for U.S. financial markets and Federal Reserve policy if the deficit continues to increase?

**A:** We do not believe the federal budget surplus will be restored before the end of the decade. Part of the reason has to do with the war on terror and the creation of the Department of Homeland Security. These two ongoing activities have taken on the budgetary equivalence of a non-discretionary expenditure. In other words, growth in spending and entitlements of these efforts may take on a somewhat permanent character. The war on terrorism and regional conflicts like Iraq will be very expensive to prosecute.

The second reason is one to which we alluded above, namely the relentless growth of non-discretionary items as a percent of the federal budget. Federal Reserve Chairman Alan Greenspan recently highlighted the challenges such commitments will present in the near future, especially in light of unfavorable demographic trends. He put forth several suggestions, such as putting the federal budget accounting system on an accrual basis, which we hope will be implemented. However, where the government is concerned, speed in reform is not expected. So, even with a return to trend growth in GDP over the next couple of years, budget deficits will likely persist. While deficit spending does not pose a near-term threat to pressure interest rates and inflation higher due to significant slack in the economy, once the economy is growing more robustly, deficit-induced inflationary pressures may surface. Increased inflationary expectations would also put pressure on the U.S. dollar to depreciate further.

**Q:** Will the euro provide a major long-term challenge to the U.S. dollar as the currency of choice for global trade and financial transactions? Will Europe be an attractive place for U.S. investors in coming years?

**A:** The E.U. has a stated goal of overtaking the U.S. as the world's most competitive economy by the year 2010. Considering the pace of political, fiscal and structural reform thus far achieved, we place a very low probability of this occurring. We are not being cute when we suggest that the greatest threat to long-term U.S. economic pre-eminence comes from China, not Europe. At the end of the 1990's, the U.S. dollar accounted for over 60% of the world's currency reserves, while euro-derived currencies (e.g. German deutsche mark) accounted for only 15%. In private sector use, the U.S. dollar accounted for over 87% of foreign exchange transactions. We do not believe that the euro will overtake the dollar any time in the foreseeable future. However, financial markets that currently conduct financial transactions using the U.S. dollar may begin to use the euro instead, especially in countries that are near the euro area and that trade more extensively with the euro area than with the United States. Too, as euro-area markets become more fully integrated, the euro is likely to play an increasing role in international financial transactions. We believe that Europe offers attractive investment opportunities, if they are able to quickly execute labor market and other structural reforms.

**Q:** Will Japan ever climb out of its economic malaise? How do you see Japan's problems impacting the rest of the global economy? When will it be a good time to invest in Japan?

**A:** We have discussed Japan's problems at length above, so we will dedicate this section to the impact Japan's problems have on the rest of the global economy, as well as sign posts indicating a good time to re-allocate significant investment funds to Japan.

Reform of the Japanese financial system could not take place in a more challenging context. The growth drivers in Japan are their export industry and manufacturing industry, which are closely related. The depreciation of the U.S. dollar is starting to impact the competitiveness of Japanese produced goods. Their economy is in deflation, and pricing pressures can only increase as China becomes more of a factor in world production. Lack of Japanese reform that would reverse Japan's decline have hindered world GDP growth, and should continue to do so over the next two years.

The following developments would cause us to reassess our negative investment view of Japan: financial reform in the guise of bank failures and mergers; full recognition of bad debt on bank balance sheets; removing restrictions on foreign direct investment; labor market reforms; continued procedural reform for the Bank of Japan and corporate governance-regulatory reform.

**Q:** Are there risks of additional financial crises in the emerging markets? Which emerging markets are at greatest risk, in your view? Which emerging markets present the best investment opportunities and why?

**A:** We believe three major emerging markets are at risk of financial crises: Brazil, Venezuela, and Pakistan. Venezuela is run by a dictator who has angered the producers of their greatest source of wealth, oil. Massive labor strikes have already wrecked the economy, and political unrest remains. In Brazil, even if the newly elected government decides it is in their best interests to reform, they may be blocked from within by radical elements of their own party. Time is also not on Brazil's side. Even if they manage to muddle along, disaster is looming. Brazil would likely be forced to default on its debt if they have to roll over their debt at current market rates, which seems likely.

Emerging markets that present the best risk-adjusted investment opportunity are Eastern European countries that are slated for E.U. membership in 2004. The reason is that in order to gain E.U. membership, these countries must put into place government, fiscal and monetary reforms that are designed to lower inflation, modernize their productive capacity, and replace centrally-planned economies with market-driven mechanisms. Inflation and interest rates should continue to fall, and stock markets should continue to benefit as these countries converge to E.U. economic criteria. We include in this group of countries Poland, Hungary and also Russia. We also like Taiwan, as their government was quick to realize the threat China poses to its manufacturing base. Taiwan is transforming itself into a consumer-focused, service-driven economy. If the stand-off with North Korea subsides, Taiwan will be an excellent investment opportunity.

**Q:** Are G-7 leaders and international financial institutions, such as the IMF and World Bank, taking adequate measures to prevent or limit potential damage from future global financial crises?

**A:** G-7 leaders and international financial institutions can take several measures to limit potential damage from financial crises. Examples include; reforming the operational mandates of sovereign central banks to promote independence of policy implementation from political pressure, and promoting corruption-free self-regulatory agencies that demand clear corporate disclosure and support conservative financial reporting standards.

We note, however, that the study of financial crises and “contagion” is a very new field. It has been generally established that about half of the transmission of financial shocks from country to country can be attributed to international trade relations. In addition, a significant portion of an isolated shock is transmitted from like market to like market (e.g. currency market shock in one country affects the currency market of another). Unfortunately, other findings in the research are quite ambiguous. Policy makers need a clear theoretical foundation that suggests specific policy advice. In the absence of a firm theoretical foundation, the best that policy makers can do for now is to create regulatory structures that increase the financial flexibility of a nation to endure economic turmoil.

## **Investment Policy Development – Risks and Opportunities**

We will devote the rest of the investment proposal to the development of our recommended strategic investment policy for Worldwide Industries’ pension fund and our tactical views on where the greatest risks and opportunities lie. We will also discuss realistic investment return expectations taking into due consideration the employees’ general risk profile. Finally, we will end with a summary of expected benefits from adopting Atlas Investment Advisors as Worldwide’s pension fund manager.

### ***Recommended Strategic Investment Policy***

AIA selected the following asset classes to include in the strategic investment benchmark: U.S. Government bonds, U.S. equities, Japanese equities, European and Oceanic equities, Emerging Market equities, and U.S. real estate. Specific market indexes were chosen to develop the weighting scheme for the individual components. The following table lists the indices chosen, recommended allocation weights, and allowable allocation range for each index:

<b><i>INDEX</i></b>	<b><i>Neutral Allocation</i></b>	<b><i>Allocation Range</i></b>
Ibbotson Long-term U.S. Government Bond Index	20%	15 – 25%
S&P 500 Stock Index	40%	35 – 45%
MSCI EAFE x-Japan Stock Index	20%	15 – 25%
MSCI Japan Stock Index	10%	5 – 15%
MSCI Emerging Markets Stock Index	3%	0 – 6%
NAREIT Equity REIT Index	7%	4 – 10%

*Table 2 – Strategic Benchmark Component Weights*

We conducted extensive historical and numerical research to determine the neutral allocation weights for the strategic benchmark. Our research included correlation studies of major index returns over the past 30 years, as well as normalized estimates of long-run expected returns and standard deviations. The weights themselves were specified using a quadratic optimization algorithm, taking into consideration conservative estimates of the benefits of diversification through the use of unfavorable variance-covariance regimes. Since we believe trends in globalization will lead to greater economic integration, we do not want to overestimate the expected benefits from diversifying investment assets overseas.

***Recommended Tactical Investment Policy***

We present below our expected asset class returns for calendar year 2003. We developed our tactical views by considering the prospects for GDP growth in the major developed economies, inflation expectations, interest rate forecasts, and other fundamental and structural considerations. We also attempted to quantify various risks to our forecasts by running Monte Carlo simulations of expected returns. A unique aspect of the type of simulation we employ is that the scenarios generated by the simulation take into account expected correlations among asset class returns. We believe this provides a much more realistic picture of likely outcomes than traditional Monte Carlo analysis might suggest.

<b><i>INDEX</i></b>	<b><i>Expected Return</i></b>	<b><i>Expected Standard Deviation</i></b>
Ibbotson Long-term U.S. Government Bond Index	4.50%	7.25%
S&P 500 Stock Index	6.50%	11.0%
MSCI EAFE x-Japan Stock Index	6.00%	11.5%
MSCI Japan Stock Index	5.50%	13.0%
MSCI Emerging Markets Stock Index	10.0%	23.5%
NAREIT Equity REIT Index	5.25%	8.75%

*Table 3 – Tactical Benchmark Component Forecasts*

Our short-term investment views lead us to the following recommended tactical policy benchmark. We include a comparison to the strategic benchmark in order to provide an indication of where we see opportunity:

<i><b>INDEX</b></i>	<i><b>Tactical Allocation</b></i>	<i><b>Tactical Allocation vs. Strategic Allocation</b></i>
Ibbotson Long-term U.S. Government Bond Index	18.50%	-1.5%
S&P 500 Stock Index	43.00%	+3.0%
MSCI EAFE x-Japan Stock Index	21.75%	+1.75%
MSCI Japan Stock Index	5.00%	-5.0%
MSCI Emerging Markets Stock Index	6.00%	+3.0%
NAREIT Equity REIT Index	5.75%	-1.25%

*Table 4 – Tactical Benchmark Component Weights*

AIA then derived an expected pension fund return by combining the tactical allocation benchmark with our expected asset class returns. Doing so provides Worldwide’s pension fund with an expected 2003 return of approximately 6.10%, with an expected standard deviation of 10.4%. Probabilistically speaking, the expected return has an approximately two-thirds chance of falling between -4.3 – 16.5%. Depending on the correlation regime selected, our Monte Carlo simulations point to an expected return of between 5 – 7.5%. All returns are reported in nominal terms. Given our views on expected inflation, the expected real return should roughly fall between 3 – 5%.

### ***Risks and Opportunities***

We now provide a qualitative assessment of risks and opportunities in the global financial markets and our investment strategy. Our tactical policy benchmark suggests the following:

- Slight underweight of U.S. Government Bonds versus the strategic benchmark.
- Moderate overweight of U.S. equities versus the strategic benchmark.
- Slight overweight of European and Oceanic equities versus the strategic benchmark.
- Significant underweight of Japanese equities versus the strategic benchmark.
- Significant overweight of emerging market equities versus the strategic benchmark.
- Slight underweight of Real Estate versus the strategic benchmark.

We project interest rates to rise slightly in the U.S. during the coming year. Our forecast for the year-end 10-year U.S. Treasury Note yield is below the consensus forecast of

4.8 – 5.0%. The risks to our forecast include faster than expected growth in the U.S. and/or an unexpected rise in inflation expectations. Our slight underweighting recognizes these risks. In addition, because we forecast sub-par growth for the Euro Zone in 2003, we suggest that a 5% position be allocated to 10-year Euro Notes. If Europe is successful in containing wage inflation, we believe the long-end of the yield curve offers good value. Actually, we would be inclined to suggest a barbell position, where one holds a shorter duration instrument together with a longer duration instrument. This position carries greater positive convexity than a position that is concentrated on one maturity. We believe the position should be un-hedged, because we also call for the euro to strengthen moderately versus the dollar through the balance of the year. Allocating 5% of the portfolio to European fixed income should provide a 10 – 20 basis points pick-up in absolute return, if the currency bet is successful.

Please note that foreign fixed income is not part of the recommended long-term strategic investment policy. That is because currency returns make up about 70 – 75% of the total return from a foreign bond investment from a U.S. investor's point of view. Currencies are also extremely volatile, so that holding foreign bonds as part of a long-term allocation adds volatility but does not increase returns in a substantive fashion. Therefore, they are only considered in a tactical sense.

Our total return forecasts for the U.S., Europe/Oceania, Japan, and equity REITs are derived from an adjustment to normalized historical returns. For example, long-run real S&P 500 earnings growth in the U.S. closely tracks long-run real GDP growth. Therefore, the forecast total return for U.S. equities is equal to forecast real GDP growth plus inflation plus dividend yield. According to our forecasts, that total equals 6.5% for the coming year. Total returns for other major equity indexes, as well as equity REITs, are derived in a similar manner.

The risks to our equity market forecasts are biased to the downside. Risks include an extended war in Iraq, flaring of hostilities on the Korean peninsula, another horrible terrorist attack on U.S. soil, a fall-off in consumption in the U.S., leading to further business cut-backs and lay-offs, continued failure of Japanese officials to institute real reform (we are as underweight Japan as possible), and failure of European policy makers to reign in wage inflation and institute labor market reforms. While we consider our base case return scenario to be realistic and conservative, the above risks to our forecasts cannot be fully discounted.

We believe the greatest tactical opportunity lies in emerging market equities. We cite several reasons:

- Emerging markets are very cheap relative to the S&P 500 on a trailing P/E basis.
- U.S. fund flows into emerging markets have bottomed, and are turning positive.
- Emerging market performance has a very tight positive correlation with developed countries' monetary easing cycle.
- Emerging market performance has a very tight positive correlation with OECD leading economic indicators, which have shown recent signs of improvement.

The risks to our forecast include double-dip U.S. recession, crises in Japan that cause a large devaluation of the yen, and emerging market systemic risks that act as a “contagion,” such as a default in Brazilian sovereign debt or civil war in Venezuela that leads to an increase in risk premia for all emerging markets.

## **Risk, Return, and Worldwide Industries’ Pension Obligations**

At the outset, AIA recognized Worldwide’s desired pension plan objective of earning a real return of 7 – 8%, and assumed that this rate of return would fully fund actuarially determined pension plan liabilities. As noted above, our forecast real return lies in the range of 3 – 5%. We suggest that given Worldwide employees’ risk-averse profile and AIA’s projected low capital market returns, the real return target of 7 – 8% over the short term appears aggressive.

One might be tempted to change the asset allocation in order to achieve higher expected returns. If AIA’s forecasts are correct, that would mean committing a significant amount of pension fund assets to emerging market equities in hopes of achieving a higher real return. However, as Worldwide has learned from past experience, this is an extremely risky strategy that may further jeopardize Worldwide’s ability to fully fund its pension fund liability.

The most prudent course of action is to establish an appropriate long-term asset allocation benchmark, taking into account the risk-averse nature of Worldwide’s employees. If one applies the strategic benchmark weights to a normalized set of asset class returns, one might expect to earn a nominal return of about 8.5% per annum. Backing out inflation, we believe a realistic long-run real rate of return target should lie in the vicinity of 5 - 6% per annum. The near term liabilities of the pension fund and general risk-averse nature of the employee base compel AIA to urge Worldwide Industries to reassess its total real return objective.

## **Statement to the Employees of Worldwide Industries**

Atlas Investment Advisors strongly believe that the best opportunity for the employees of Worldwide Industries to achieve their retirement goals is to embrace the concept of diversification. We apply our investment philosophy in a highly disciplined manner, one that is designed to maximize your return, given the relatively risk-averse nature of the employees of Worldwide.

We would like to take a moment to mention a couple of basic “truths” that guide our diversified approach to managing investment risk:

- Future asset class returns are unknowable.
- Variation of return differences between asset classes is a function of the volatility of the returns of each asset class and the correlation between the asset classes. In other words, it is extremely difficult to predict the return difference between asset classes during any time period.

- There does not appear to be any significant relationship between correlation and differences in return between several key asset classes over time. In other words, even when correlation is high, it pays to diversify one's investments.

Given the above, we confidently suggest that the clearest path to reaching one's retirement goals is not to chase the latest investment fad. Rather, one is best served by setting firm investment return objectives, recognizing the level of risk one is willing to tolerate, and implementing a plan that is designed to maximize the chance of reaching one's investment goals.

We recognize our duty to manage risk in a disciplined, strategic way that has the best chance of producing important, long-term results. Atlas Investment Advisors welcomes the opportunity to help the employees of Worldwide Industries achieve their retirement goals.

*Atlas Investment Advisors*