Portfolio Evaluations, Inc.
THE BENCHMARK IN INVESTMENT CONSULTING

July 13, 2009

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INVESTMENT UPDATE: TIAA REAL ESTATE ACCOUNT

On July 6th, PEI had a conference call with Peggy Brandwein, one of the portfolio managers for the TIAA Real Estate Account, and Tom Callahan, a client portfolio liaison for TIAA-CREF. Our discussion focused on redemptions, valuation practices, underlying holdings, and leverage, among other topics. From an organizational standpoint, Brandwein noted that there have been no major changes to the Real Estate team during the past 18 months. The only notable change has been a temporary move of some of the team's acquisition resources into asset management work because there have not been any property acquisitions in the portfolio in over a year.

While several other direct property funds have instituted redemption freezes in order to prevent the forced sales of underlying properties, the TIAA Real Estate Account is not permitted to freeze redemptions. The account must allow for quarterly liquidity due to a contractual obligation required by the New York State Insurance Department when the account was established in 1995. When redemptions heightened in late 2008, management sold off the account's liquid securities to satisfy withdrawal requests. After redemptions exceeded the value of the account's liquid securities, TIAA-CREF's general account purchased units of the portfolio in order to backstop the account and prevent any forced sales. This liquidity guarantee will be in place as long as necessary. If the general account is forced to acquire 45% of the account due to redemptions, the Real Estate Account's independent fiduciary will then decide whether it is in the best interest of the shareholder to allow more purchases by the general account or to sell properties. However, at present, the TIAA-CREF general account owns around 10% of the Real Estate Account.

PEI inquired about the status of the account's joint venture with Developers Diversified Realty (DDR), which is the account's largest holding. The account purchased a portfolio of more than 60 community retail centers with DDR in 2007 from Inland Retail Real Estate Trust, Inc. At the time, the fund was experiencing significant cash inflows and decided to invest in this large portfolio as a cost effective way to put the new money to use. The retail properties were chosen because the account was significantly underweight to the retail sector at the time and management saw the joint venture investment as a quick and efficient way to gain exposure in the space. As when purchasing entire portfolios, management had expectations that some of the properties might not meet the quality standards that most of the account's properties exhibit and was prepared to sell those properties. Although the investment team has a list of properties within the DDR joint venture portfolio that it would like to sell, management decided that current real estate market conditions do not allow them to sell the properties at what they believe to be true value. However, the fund does have a sales program in place that is ready to go into effect once market conditions improve.

Along with the DDR joint venture, PEI also discussed the account's purchase of a small portfolio of about 11 Houston apartment complexes in 2008. Although management finds Houston residential property attractive, a couple of the complexes were believed to be of lower quality and were subsequently sold. The sale price gave the team a more current piece of information regarding the value of similar Houston properties. With this information, the rest of the Houston portfolio was reevaluated, but because an independent appraisal deemed the complexes that they held to be of higher quality than those that they sold, their Houston holdings were not marked at the same prices that the others were sold for.

During our dialogue, Brandwein explained management's handling of the account's debt and their intentions going forward. The account currently has around $4 billion of debt, which is equal to about 30% of the portfolio, owned by more than 20 different lenders. The three largest lenders to the portfolio are MetLife, Bank of America, and the New York State Teacher's Retirement System. The account may not take on additional debt once leverage reaches 30%, which means the account may not incur more debt at present valuation. However, the portfolio is not restricted from holding debt worth above 30% of the portfolio if the percentage increase is due to a decrease in the account's underlying property values. Management does not project the portfolio's leverage will reach above 50% and their intention is to decrease the account's current debt levels. To put the portfolio's debt level into perspective, additional leverage worth $550 million was received in 2008 to purchase a group of apartments. At the time, this added debt brought the account's total leverage to just under 27%. In terms of the account's upcoming debt repayment schedule, the contracts for the $40-$50 million due in 2009 have all been extended. In 2010, the account is scheduled to pay back 10-15 loans, amounting to $740 million. All of the loans due in 2010 have extension provisions, and the team is currently working to have these extended. In 2011, the account is due to owe under $100 million, while in 2012 it will owe around $800 million. The portfolio's payment schedule is set up so that under 20% of its debt matures each year. The account is not in breach of any covenants.

Looking forward, management believes the portfolio is well-diversified in terms of sectors and geography. However, they do not see the office sector, which comprises around 52% of the portfolio, being strong in the future. As such, management plans to cut back on its exposure to the sector. In turn, there are plans to better diversify the portfolio's retail holdings, which lean heavily to properties in the southeast U.S. due to the joint venture with DDR, and to add more residential and industrial real estate. Their intent is to gradually exit some areas, particularly the suburban office space, as market conditions allow.

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January 20, 2009

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INVESTMENT UPDATE: INVESTMENTS WITH MADOFF

Latest news reports show investors had about $43 billion with money manager Bernhard Madoff's New-York based firm "Bernhard Madoff Investment Securities, LLC". Individual investor and bank losses may also be included in this total of reports from funds.

Madoff was arrested on December 11 for allegedly running a $50 billion Ponzi scheme. Most of his clients include individual investors and European Banks but also U.S. colleges and nonprofit institutions, endowments, school and charities.

Within the European banks, HSBC, UBS and BNP are some of the clients with "potential exposure" to Madoff. HSBC and UBS may be liable for $3.2 bn. According to Bloomberg, HSBC said it isn't liable and UBS declined to commend. And Morgan Stanley and Citigroup may have $1.8bn. of clients cash in a fund that invested with Madoff. Spokesmen for both firms declined to comment.

At this point, the situation is still unfolding –the number of clients is changing and their total exposures are unclear. PEI will be monitoring the situation and will provide additional updates as more information becomes available.

September 17, 2008

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INVESTMENT UPDATE: FIDELITY MANAGED INCOME

Effective September 16th, the government announced that it would lend AIG, the nation's largest insurer, up to $85 billion in emergency funds in return for a government stake of 79.9% and effective control of the company. AIG Financial had been working to raise capital in an effort to stave off a downgrade by major credit-rating agencies. AIG continued to decline in the early trading on September 17th, after investors learned that the U.S. rescue may curb or halt the insurer's dividends to common and preferred stock holders. The loan would allow the insurer to refinance its debt, however the Fed does not require asset sales or the company's liquidation.

AIG provides insurance on more than $441 billion of fixed-income investments held by some of the world's largest institutions, including $57.8 billion in subprime-related securities.

Currently 20% of the Fidelity Managed Income Portfolio is wrapped by AIG. The other wrap issuers are Monumental Life, JP Morgan, Rabobank, and State Street Bank. Wrap contracts provide book value payments in situations when the market value of the stable value assets falls below book value. Thus the exposure to AIG is the difference between the market value of the underlying assets and the book or contract value in the event the assets in the portfolio must be liquidated.

Fidelity Investments has yet to provide commentary on this subject. They also have not provided us with recent cash flow information nor have they provided market value information as it relates to the AIG wrap contract.

PEI will be monitoring the situation and will provide additional updates as more information becomes available.