Minneapolis Employees Retirement Fund

800 Baker Building
706 - 2nd Avenue South
Minneapolis, MN 55402-3008
(612) 335-5950
FAX (612) 335-5940

Judith M. Johnson
Executive Director/
Chief Investment Officer

News Release

Contact Name: Judith M. Johnson
Executive Director and Chief Investment Officer
Minneapolis Employees Retirement Fund
612-335-5939

Termination of Advanced Investment Management Inc.

MINNEAPOLIS (July 26, 2002) On July 12 the Minneapolis Employees Retirement Fund (MERF) Board terminated the investment management services of Advanced Investment Management Inc. (AIM) after the Board discovered that AIM had violated the investment guidelines specified in its contract.

MERF retained the services of AIM, a Pittsburgh-based registered investment management firm, in February of 1993 for management of a synthetic enhanced S&P Index account (this is a semi passive investment strategy where a manager seeks to replicate the return of an index fund and add approximately 70 basis points in additional return).

"The MERF Board took swift action when we discovered AIM's violation of our investment guidelines, by terminating the contract and immediately halting all trading by AIM," said Judith Johnson, Executive Director of MERF.

MERF terminated AIM on July 12, 2002 and retained Pacific Investment Management Company, (PIMCO) to de-leverage the account. Trade statements clearly show that AIM began to de-leverage MERF's account after the call from Ennis Knupp on July 8, 2002. PIMCO has advised MERF that it had to sell $130 million of excess leverage on July 18, 2002 to bring the holdings in the account to the market value of the account, which was $76 million.

"This unfortunate loss underscores the importance of the board's controls and investment oversight," said Board Chair James Lind, "However, it is important for the public to understand that the loss will have no long-term impact on the financial health of the fund. Retirees and beneficiaries should understand that there will be no impact on their current benefits, no change in the amount of their checks and no interruption of payments resulting from this issue." The Executive Director noted that the cost of living increase due to retirees next January 1 will also not be impacted. Further, the City of Minneapolis and its sister employers who fund the MERF fund will not be financially impacted by the loss."

Minnesota's nine public pension funds, which includes MERF, are protected under the State of Minnesota Public Pension Fiduciary Act (Mn.Stat. 356A). AIM has certified annually that it is governed by this law and that it will follow investment guidelines.

"We believe this is a very serious breach of contract and have already referred the matter to outside legal counsel. The AIM firm is subject to the jurisdiction of the Securities and Exchange Commission and it is likely that a complaint will be forwarded to them for further investigation and, hopefully, enforcement action against the the firm." said Johnson.

The MERF Board is responsible for managing fund investments on behalf of its 6,120 members. MERF currently has 836 active working members, 200 members on deferred retirement and 5,084 members receiving monthly retirement checks. Over 60% of the active members are employed by the City of Minneapolis. Another 35% are non teaching personnel at the Minneapolis Public Schools. The remaining members are employed by the Metropolitan Airports as firefighters, police officers and general administrative personnel.

The loss has been recognized for MERF's financial statements for the year ended June 30, 2002. Despite the $9 million loss incurred in June, 2002, MERF expects that its returns for the year ended June 30, 2002 and its three year and five year returns to be comparable to the returns of the SBI. SBI manages the pension assets of the state's three large pension systems: PERA, MSRS and TRA.

MERF's annual returns have exceeded the returns of the State Board of Investment (SBI) over the most recent three year period ended in March 31, 2002. MERF's retiree post fund, where 81% of the assets are held, earned 2.7% on a three year annualized basis as of March 31, 2002 and the SBI earned 1.5% over the same time period. The most recent five year comparison between the funds showed that the five year investment performance was virtually the same. The difference in returns for the two funds over time frames shorter than five years is due to the fact that the two funds have slightly different asset allocations. Minnesota's SBI is well regarded and ranks high in comparison with other state funds. As a matter of MERF board policy MERF's investment consultant must measure the investment risk of the SBI portfolio and compare it to the investment risk of MERF's portfolio on an annual basis. MERF Board policy states that MERF's asset allocation can not have a higher level of risk than the portfolio managed by SBI.

MERF is taking the unusual step of issuing a press release in part because the client list of AIM lists several Minnesota based entities. With the collapse of the US stock market, some of these entities might infer that losses in their account are solely related to the market downturn when, in fact, a portion might be due to AIM violations of contract guidelines. Johnson said, "We encourage all AIM clients to review their portfolio in a detailed, forensic manner. Each client should ask, "What is the probability in a large client base, that only three public pension plans incurred losses due to contract violations." Johnson noted "There is a serious question that now must be addressed by every AIM client. The fiduciary question is actually quite simple. "If the internal controls at AIM were systematically over-ridden and guidelines violated day after day, even if your fund did not incur losses, what are the guarantees that would protect your pension fund assets in the future?" A list of AIM clients as of December 31, 2001 is attached to this press release. Other firms may have retained AIM in the past twelve months.

Background Information

With an enhanced index strategy, an investment manager does not purchase or sell individual stocks, which have historically been a higher risk form of investment management. Instead the manager uses the futures market to gain market exposure to the 500 stocks contained in the S&P index. Unlike owning the individual stocks in the S&P index, or investing in an S&P index fund, an enhanced strategy using futures and options requires that only a portion of the total value of the investment be paid at the time of purchase. The manager utilizes the remainder of the cash in the account to buy a high quality short duration fixed income portfolio. This strategy specifically excludes market timing and leverage.

In early February MERF requested that its investment consultant firm, Ennis Knupp of Chicago, Illinois, begin an investigation into the cause of unusual losses in MERF's account in October and November ,2001. In addition, the consultant was to determine the cause of the unusual gains in the account for December, 2001 and January, 2002. AIM had always produced returns that were slightly higher and sometimes slightly lower than the S&P index. Both the losses and the gains over the four months were statistically "outliers". The Executive Director noted that she has 32 years experience as an accountant and that her auditor's nose was telling her that something was wrong. As a result of the out-performance in December 2001, and January, 2002, Aim was eligible for a performance based fee of almost $500,000. Without this unusual performance during December and January AIM would have earned no fee for the previous year. MERF was billed and has paid a performance fee of almost $500,000.

Ennis Knupp reviewed the custody records and held discussions with AIM's President and Chief Investment Officer Thomas Allen. Ennis Knupp was not fully satisfied with AIM's response. The consultant balanced nine years of consistent positive performance against four months of unexplained performance. Ennis Knupp had further discussions with MERF's Executive Director. The consultant indicated that AIM could be retained if the consultant could negotiate additional controls on the account. Thomas Allen agreed to the new risk control measures, to be effective on April 1,2002. The new restrictions were expected to lower MERF's return over the S&P from 70 basis points to 50 basis points. In turn, the controls would limit MERF's loss potential to no more than 50 basis points under the S&P index. MERF believes that it is now clear that AIM violated not only the general contract guidelines and restrictions, but also the new restrictions they had just negotiated.

In June of 2002 MERF's Executive Director noted unusual losses in the AIM account on the daily custodian reports. Heightened monitoring of daily reports was employed due to the problems in the fourth quarter of 2001. By July 8,2002 it was crystal clear that something was very wrong. MERF ordered an immediate investigation on the same date that Ennis Knupp's other AIM client, San Bernardino County notified Ennis Knupp that they suspected that excess leverage had been applied to their account. In MERF's account there was also clear evidence of mid-month market direction bets (commonly known as market timing). Both leverage and market timing are specifically prohibited because they add significant risk to the account. When leverage and market timing exist together, a low risk account is converted into a high risk strategy most similar to a hedge fund. MERF's investment guidelines prohibit market timing. Under MERF's overlay authority AIM had to daily monitor the account to insure that there was no more than 15% leverage on the account on any day. Thus, the account could never have less exposure to the S&P than 85% of the account value and never more exposure than 115% of the account's market value. In addition the account guidelines specified that there could never be effective S&P exposure for the entire account that is less than 85%. MERF believes that the level of contract violations were significant and include the fact that AIM engaged in market timing and reduced MERF's exposure to the S&P to a low of 58% in December and increased MERF's S&P exposure to a level of 400% leverage on the account.

On July 8, 2002 Ennis Knupp began a review of holdings with consultation provided by an expert in the enhanced S&P index strategy. It was determined that AIM's account had 400% effective leverage. Ennis Knupp spoke with the president of AIM and ultimately determined that no confidence could be placed in AIM. Late in the afternoon of July 12, 2002 Ennis Knupp advised both MERF and San Bernardino County to terminate AIM as manager as soon as a transition manager could be employed to take over the management of the account. San Bernardino terminated AIM on July 11, 2002 and issued a press release on July 18, 2002 reporting that $55 million dollars had been lost as a result of breach of contract guidelines.

MERF retained PIMCO to act as transition manager and the agreement with PIMCO was executed on July 13, 2002. PIMCO could not trade the account until it had a certified list of holdings from MERFs custodian. This certified list was delivered to PIMCO the evening of July 17, 2002. PIMCO traded out $130 million of leverage early in the morning of July 18, 2002. The market continued to fall and through Friday July 19, 2002, MERF avoided an additional loss of $8 million as calculated by PIMCO. Executive Director Johnson noted that a delay of even 36 hours would have greatly increased its loss. As the markets have continued to collapse this week, MERF's exposure is exactly equal to the market value of the account. MERF's custodian is currently calculating the monitary value of orders placed by AIM to de-leverage. MERF's account beginning with July 8, 2002, the date Ennis Knupp contacted AIM and ending on July 12, 2002, the date AIM was terminated. MERF and its consultants believe that AIM placed over 400% leverage on MERF's account.

The total loss due to AIM's contract violations is $27 million. $9 million of the loss is applicable to losses in June, 2002 and the $18 million in losses is applicable to July, 2002. While the dollar amount of the loss is significant, it represents is less than 2% of the total fund.

Background on MERF

The MERF board is responsible for managing investments on behalf of 6,120 MERF members. MERF currently has 836 active working members, 200 members on deferred retirement and 5,084 members receiving monthly retirement checks. Over 60% of the active members are employed by the City of Minneapolis. Another 35% are non teaching personnel at the Minneapolis Public Schools. The remaining members are employed by the Metropolitan Airport Commission as firefighters, police officers and general administrative workers.

The MERF fund was closed to new members in 1978 and new employees hired since that date are covered by the Public Employees Retirement Fund (PERA). All of MERF's remaining active members are eligible to retire within the next five years.

The Board is advised by Ennis Knupp, a nationally recognized pension consulting firm. All of the assets are managed by independent outside money managers and no funds are managed by the fund itself. The fund is diversified broadly among asset classes. The pension funds assets are managed by nine nationally recognized independent institutional money managers. 70% of MERF's domestic equities are held in a passive index fund with State Street Global Advisors. MERF holds 46% of assets in domestic equities, 20% in foreign equities, 30% in bonds, 4% in REIT stocks and 1% in cash. 100% of MERF's investments trade daily on various stock exchanges around the world. MERF holds no direct investments in real estate, venture capital, alternative investments or hedge funds as a matter of Board Policy.

Key Dates

February 26, 1993	AIM is the successful candidate in MERF"s national manager search for a S&P 500 enhanced index investment mandate.
February, 2002	MERF requests that its investment consultant initiate an inquiry into the cause of unusual performance in MERF's account during the fourth quarter of 2001.
April 1, 2002	In February 2002 AIM agrees to stricter guidelines that are effective on April `, 2002. Investment consultant recommends that MERF board continue to retain AIM.
July 8, 2002	MERF advises investment consultant to begin urgent investigation of AIM's Management of MERF's account.
July 11, 2002	Investment consultant advises MERF to terminate manager due to contract guidelines violations as quickly as a transition manager can be hired.
July 12, 2002	AIM is terminated.

ADVANCED INVESTMENT MANAGER
12-31-2001 CLIENT LIST

ENHANCED INDEX CLIENTS

ACE, Limited (2) Self-Insurance Corporation	Dow Chemical Company	Michigan Universities
Allegheny County Retirement Board Retirement Fund (2)	Engelhard Corporation	Minneapolis Employees'
Allegheny Technologies, Inc. (2) Retirement Fund	Forum Health	Minneapolis Teachers'
Aventis Pharma (2) Employees' Retirement System	FPL Group, Inc	Missouri State
Catholic Healthcare Partners (2) Corporation	General Mills, Inc. (2)	Niagara Mohawk Power
Catholic Healthcare Retirement Trust Employees' Retirement System	Georgia-Pacific Corporation	Pennsylvania State

Celanese Americas Corporation
Group Incorporated
CIBA Chemical
Local #73
CIGNA (2)
College of St. Scholastica
Inc.
Cooper Industries, Inc.
America
Devon Energy Production Company

Health Services Retirement Plan

Hershey Foods Corporation

Hoffmann-LaRoche, Inc. (2)
Intermountain Health Care

Iowa Health System

Lincoln Electric Company

Public Service Enterprise

Sheet Metal Workers

Tennant Company
Toyota Motor Sales, USA,

United Mine Workers of

Viacom Inc. (2)

( ) Number of Accounts

<u>OTHER MANDATES CLIENTS (HEDGING AND RISK MANAGEMENT CLIENTS **)</u>

Allegheny Technologies, Inc.
Aventis
Beckwith Machinery Company
Carnegie Mellon University
CBS, Inc.
Consolidated Natural Gas Company
Delta Airlines
Hoffmann-LaRoche, Inc.
ICMA Retirement Corporation
Ikon Office Solutions

Keebler Company
Kerr Group
Kresge Foundation
Public Service Company of New Mexico
Public Service Enterprise Group Incorporated
St. Francis Hospital
Stackpole Corporation
Uniroyal Corporation
University of Rochester

** Current and past hedge clients