

## WEEKLY MARKET MONITOR SEPTEMBER 10, 2007

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### STRATEGY OF A LONG-TERM INVESTOR IN A TIME OF RISK RE-DISCOVERY

The investment account that supports the TIAA Traditional annuity product\* is one of the largest single investment vehicles on earth. The account has roughly \$170 billion in assets and is investing approximately \$25 billion in this year alone. In order to avoid a drag on dividends that would result from stockpiling cash, TIAA investment strategy calls for the account to be fully invested. In practice, that is accomplished by deploying investment dollars as they are collected regardless of the gyrations in the financial marketplace. However, this is not to say that marketplace gyrations have no impact or import for TIAA. Financial market developments over the last few weeks offer a useful context for explaining the impact and import of financial gyrations to TIAA.

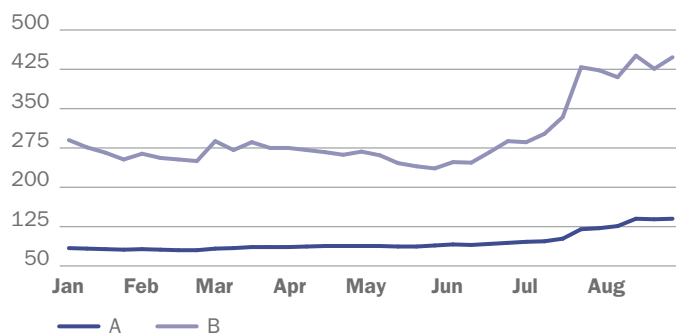
TIAA is a long-term, long-view investor. In part, this is necessary because our Traditional annuity product requires a long-term commitment from our participants that should ideally be matched to investments of similar duration. As a result of the long-term commitment of participants, the portfolio can be managed with a long-horizon view that is especially valuable when markets are in turmoil. In addition, the book value regulatory accounting that governs TIAA encourages long-term investing. Balances are not marked to market value which fluctuates day-by-day, but rather carried at book value which is the amount of the principal contributions plus accumulated dividends. The market value of the investments in the portfolio does indeed fluctuate with market conditions, but the fluctuations

are not meaningful for TIAA participants unless they are accompanied by decay in the credit quality of the investments. Credit quality decay translates into accounting losses which TIAA nets from the reserves that have been accumulated for that purpose. Those reserves, which are part of TIAA's capital, have adequately covered losses throughout the 80+ years of the Traditional annuity's history.

## IMPACT OF RECENT DEVELOPMENTS ON THE TIAA INVESTMENT PORTFOLIO

Let's turn now to recent financial developments and their impact on the TIAA investment portfolio. First, after a very long period of very low returns to risky investments, investors began re-pricing risk in June by demanding higher yields on lower quality securities. The re-pricing was due in part to the problems surrounding sub-prime residential mortgages and the structured securities that contain them. Those problems prompted investors to re-consider the returns on other securities in light of heightened awareness of risk. Such rediscovery of risk has happened periodically in the past following similar periods of abundant liquidity and very low returns to risk, most recently in 1998.

### A-QUALITY AND B-QUALITY CORPORATE BONDS SPREADS OVER TREASURY RATE



At the same time, riskless Treasury bonds have been experiencing declining yields because of increased demand from investors seeking a safe haven. Treasury yields are the base for pricing all fixed income securities with risk returns or spread added to reflect the relative risk of the particular security compared with riskless Treasuries.

### 10-YEAR U.S. TREASURY RATE



The higher risk spreads and lower yields on Treasury bonds are together affecting the value of fixed income securities. Bonds with the highest risk and lowest credit quality ratings have suffered the most severe value declines because spread widening for them is much larger than the decline in Treasury yields. For low-risk, highly-rated bonds, the two forces have about washed out leaving value unchanged. TIAA's investment portfolio is largely unaffected by this re-pricing because credit quality has not deteriorated thus far and because securities are carried at book value. The more important point for TIAA is that the risk re-pricing is creating an opportunity to receive higher returns on the securities that we buy in the weeks and months ahead.

The **second** development is the very real deterioration in the housing and residential mortgage sector of the economy. Home builders, suppliers of building materials and home décor and appliances, residential mortgage bankers and other related businesses are suffering from the large overhang of unsold homes, bottlenecks in residential mortgage availability, and mushrooming delinquencies on sub-prime residential mortgages. TIAA's portfolio has minimal investment in these industries leaving us largely unharmed.

The **third** development roiling financial markets in recent weeks is the so-called credit crunch. Reports of canceled and postponed corporate buy-outs, foiled real estate transactions, and delayed or restructured debt offerings have been rampant as investors re-consider risk pricing. The commercial paper market, which provides short term financing, has been particularly hobbled due in part to its concentration of paper backed by assets including residential mortgages. The Federal Reserve and foreign monetary authorities have stepped up to inject liquidity into the system but the problem appears

to be persisting. For TIAA, the credit crunch also offers opportunity because we are a cash investor with a steady flow of available cash. As highly leveraged investors move to the sidelines, competition for attractive assets diminishes and pressure on prices eases. With cash in hand, TIAA is well-positioned to benefit.

The **fourth** development is the heightened risk of recession. If the credit crunch persists unabated, economic growth prospects for the quarters ahead will shrink. Forecasters are re-evaluating their outlooks as each new piece of data is released; most are raising their assessments of risk and edging down their growth forecasts for 2008. The consensus is expecting that the Fed will come to the rescue and lower interest rates to prevent recession. A few believe that the Fed will act too late allowing growth to drop to a near-recession pace. The TIAA investment portfolio is sensitive to recession largely through its impact on credit quality of the fixed income portfolio and the income flow from the non-fixed income portfolio. The latter amounts to roughly 7% of the portfolio and is made up largely of real estate.

Recession typically involves material deterioration in credit quality including an increase in bond downgrades and heightened defaults; these create losses which are charged against the portfolio's reserves. Real estate and private equity returns can suffer as well. Historically, TIAA has weathered

recessions without difficulty as recognized in our strong financial ratings which are based in part on our high capital ratio.

In sum, if the financial gyrations now underway are confined to risk re-pricing, sector distress in housing and residential mortgage related areas, and a transitory credit crunch, TIAA may potentially benefit. However, if recession cannot be avoided, the benefits will be offset by credit quality and investment performance pressures on the portfolio. Our strong capital resources and long history of weathering recessions will be called into service in this eventuality. On a day-to-day basis, investing continues without interruption and with special focus on seeking benefit from troubled times.

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