2003
Annual Report

"Today, for tomorrow"

FRR

Fonds de réserve pour les retraites

Contents

2003 Annual Report

Raoul Briet
Chairman of the Supervisory Board

Letter from the Chairman of the Supervisory Board and the Chairman of the Executive Board

Enacted by legislation in 2001, aimed at meeting the long-term financing needs of the French pay-as-you-go retirement system, the FRR truly began operations in 2003.

In terms of financial management, then, this inaugural year must be viewed as one of transition. At the same time, fundamental decisions – which will have a lasting impact on the Fund – were made in 2003 and then rapidly implemented. These underlying principles concern not only the Fund's global investment strategy, but also the process by which its asset managers are selected and internal organizational procedures.

The general investment policy orientations for the Fund's assets were determined in April of 2003. They call for a target allocation of 55% in equities and 45% in bonds, and make full use of the options allowed by law in terms of geographic diversification (25% outside the eurozone). This target allocation was then used to build a portfolio comprised of twelve asset classes and involving 39 investment management mandates.

The international request for proposals that was rolled out in July of 2003 was exceptional in terms of size: 16 billion euros. This sum corresponds to the Fund's aggregate resources at year-end 2003. Due to the number and the quality of the asset management firms that responded, the RFP generated a considerable workload. This was all the more so given that the Executive Board, assisted by a Manager Selection Committee made up of recognized experts, was committed to ensuring at every step that European directives and the French government procurement code in terms of transparency and equal consideration of applicants be respected to the letter.

This first year was also devoted to building the Fund's organizational foundations. Under the supervision of the Executive Board, FRR staff worked hard to put in place a set of processes and information systems adapted to the Fund and designed to ensure the highest standards of security in administration and risk management. In these areas, the Reserve Fund can count on the *Caisse des dépôts*, an experienced provider of fund administration services.

Francis Mayer
Chairman of the Executive Board

It is in through the choices they make that the Executive Board and the Supervisory Board – each acting within its prerogative – intend to shape this new player.

The FRR must conduct itself as a long-term investor. Working to ensure the long-term survival of the French pay-as-you-go retirement system, it must maintain the best possible trade-off between the returns provided by the funds entrusted to it by the nation and the management of the risk inherent in each asset class in which investment is made. In meeting this obligation, the Fund may make full use of all existing opportunities for diversification, and also participate in the global socially responsible investment movement, in particular through the responsible exercise of proxy voting rights.

The FRR is also committed to becoming an institutional investor of choice – innovative and demanding, committed to establishing long-term partnerships with financial intermediaries while keeping operating costs at levels that compare with the best global players. Indeed, the best way of defending the interests of the public trust, France's future retirees, is by making transparent and professional decisions through its governing bodies.

The Fund will begin operations in the second quarter of 2004, when the management selection process is completed and the resulting mandates are gradually activated as market conditions permit. At the same time, discussion on diversification (venture capital, dedicated SRI component, etc.) and proxy voting procedures (fine-tuning the guidelines applicable to investment management firms) will continue. The Supervisory Board laid the foundations for both in its July 2003 resolution, which will serve as the basis of the Executive Board's recommendations of best practices, inspired by examples from institutional investors in France and abroad.

This places a number of challenges before Fund employees, and as many opportunities to demonstrate their professionalism. For the FRR – a newcomer in the French and European intuitional investment landscape – they offer an opportunity to affirm its identity.

Raoul Briet
Chairman of the Supervisory Board

Francis Mayer
Chairman of the Executive Board

July 2004

Supervisory Board

Chairman
Raoul BRIET

Vice-chairman
Jean-Louis BEFFA
Chairman and CEO
Saint-Gobain Group

Vice-chairman
Jean-Christophe LE DUIGOU
Representing the CGT

Other Board members:
Yves BUR
Member of Parliament

Marc LAFFINEUR
Senator

Adrien GOUTEYRON
Senator

Dominique LECLERC
Senator

Jean-Pierre JOUYET
Representing the French Minister
of the Economy

Pierre-Mathieu DUHAMEL
Representing the French Minister
in charge of the Budget

Dominique LIBAULT
Representing the French Minister
in charge of Social Security

Pierre RICORDEAU
Representing the French Minister
in charge of Social Security

Bernard CARON
Representing the MEDEF

Alain LECLAIR
Representing the MEDEF

Guillaume SARKOZY
Representing the MEDEF

Dany BOURDEAUX
Representing the UPA

Jean-François VEYSSET
Representing the CGPME

Jean-Paul LE BAIL
Representing the CFDT

Solange MORGENSTERN
Representing the CFE-CGC

Jean-Jacques POUJADE
Representing the CGT-FO

Isabelle SANCERNI
Representing the CFTC

Executive Board

Chairman
Francis MAYER

Other Board members
Antoine de SALINS

Philippe MOST

Manager Selection Committee

Chairman
Antoine DE SALINS

Alain HINDIE
Consultant

René KARSENTI
Director General of Finance, EIB

Christopher NOWAKOWSKI
International consultant

Alain ROBIDEL
Associate director, AC2F Consultants

The FRR: playing an instrumental role in the long-term financing of pensions

The FRR – established to consolidate the French pension system post-2020

The French retirement system has undergone a series of adjustments in the last decade, all of them aimed at achieving and maintaining a healthy balance over the long term. The system, which is made up of mandatory plans for workers in various fields, is built on the related notions of pay-as-you go (commonly referred to as 'PAYG' or 'PAYGO') and inter-generational solidarity. It faces a number of key economic challenges, notably those resulting from shifting demographic realities. These changes are embodied in two phenomena of roughly equal importance. The first is the arrival of the so-called baby boomers on the retirement scene, which means that, as of 2005, some 800,000 retirees will be newly entitled to pensions each year, as opposed to around 500,000 today. The second salient phenomenon is the steady increase in life expectancy – and hence in the duration of the retirement payout period – for those approaching 60 years of age today. In fact, from an average of 22 years at present, retirees in 2040 will be receiving retirement benefits for an average of just over 28 years, an average increase over the period of roughly two months per annum.

On the basis of French legislation in force in 2001 (i.e., without taking into account the impact of the reform that was introduced by the recently passed Act of August 21, 2003), the Pensions Stewardship Council (*Conseil d'Orientation pour les Retraites*) estimated that the global financing requirement of all mandatory retirement systems in place at the time would be equal to approximately two percentage points of GDP by 2020, climbing to twice that proportion – i.e., to four percentage points – by 2040. As the Council also pointed out, deficit projections differ rather significantly from one plan to the next. Estimates for private sector wage earners – the largest cohort in the system – suggest that the looming financial imbalance will deteriorate sharply between 2020 and 2040, from a shortfall in constant euro terms of 11 billion euros in 2020 to nearly 37 billion euros by 2040.

Inspired by this global forecast and foreseeable timeframe, the decision to establish the FRR was made in 1999. The aim of the Fund is to set aside and invest significant financial resources between now and 2020, making the accrued resources gradually available thereafter to eligible plans, in particular – and in accordance with applicable law – the basic mandatory retirement plan set up for wage earners in the private sector. This external contribution is intended to provide for a better distribution, over time and between generations, of the efforts that will be required to ensure the long-term financial equilibrium of such plans. Hence, the explicit purpose of the FRR is to act as a "smoothing mechanism." Given its deliberately transitory nature, however, the FRR is not intended to serve as a substitute for the necessary reform of existing retirement plans. Instead, the Fund's dual aim is to render these adjustments more gradual and avoid passing an unacceptably large portion of the burden on to future generations.

What is a reserve fund ?

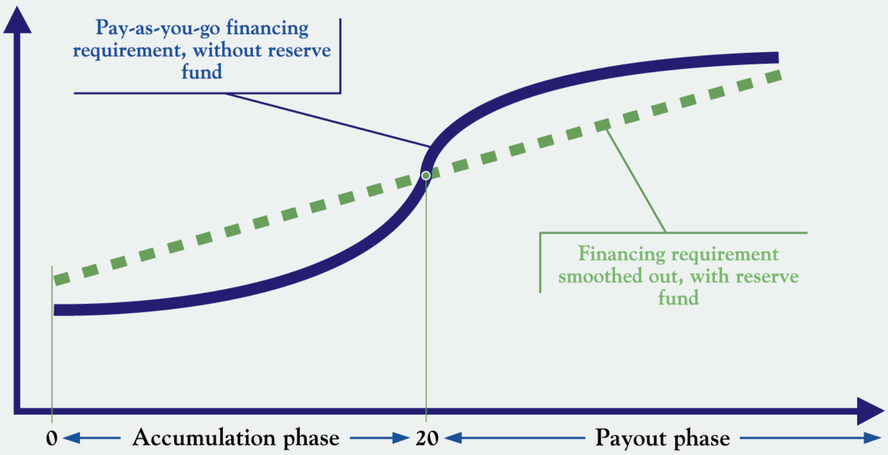
A reserve fund is defined as an accumulation of monies that are capitalized within or for the benefit of a pay-as-you-go retirement plan. It involves the communal pre-financing of a portion of anticipated and promised future plan benefits. Reserve funds of this type operate on a multi-year distribution formula that distinguishes between the successive phases of accumulation and payout, such that the plan achieves a global balance over the longer term (i.e., several decades).

Three types of reserve fund exist:

- Precautionary fund: Existing reserves, which are equal to several months of expenditure, are used to offset the impact of business cycle troughs on fund balances. These reserves are the equivalent of cash kept on hand to cover financing contingencies during low points in the economic cycle.

- Smoothing fund: This type of fund enables the orderly transfer of savings to pre-finance some of the additional costs incurred by the retirement of baby boom generation cohorts. This pre-financing arrangement is intended to limit future increases in system contributions from active workers and their employers. This type of fund is temporary (see graph below).

- Non-lapsing fund: This type of fund enables the underlying plan to top up current revenues from old age and retirement contributions with interest earned. It constitutes income-generating assets (particularly real-estate assets), and serves as a third financial pillar that operates alongside employers and active wage earners – the other two pillars.



Practices abroad

In the past few years, a number of the world's industrialized nations have set up reserve funds intended to pre-finance all or a portion of future public liabilities, in particular those related to the impacts of demographic aging on the balanced growth path of public PAYGO retirement systems.

In some countries, these funds have been established ex-nihilo and are subject to various rules regarding administration, topping up and financial management that arise directly from the structure of prevailing retirement system and fiscal policy practices. This is the case in the Netherlands, Spain, Ireland, Norway, New Zealand and France.

In countries whose PAYGO retirement systems had previously accumulated financial reserves, system reform provided an opportunity to change the regulations pertaining to investment and financial management, with the aim of optimizing returns and investment strategy. This is the case in Sweden, Finland, Japan and Canada.

The two cases briefly described below – one involving a long-standing fund and the other of very recent establishment – show just how diverse such systems can be in terms of the objectives assigned to the fund, the amounts involved, the type of financial resources allocated, and the investment management strategies adopted. They also illustrate that, differences in local culture and practice notwithstanding, these funds are always founded on the underlying notion of intergenerational solidarity and a communal vision.

Norwegian Government Petroleum Fund (NGPF)

A major exporter of oil and natural gas, Norway reaps the high financial rewards of this activity. Faced with the prospect of diminishing oil revenues in the future, public policymakers in Norway responded in 1990 by setting up the Norwegian Government Petroleum Fund. The aim of the fund is twofold: to equalize the use of oil revenues over a long period, while serving as a buffer in the short term to smooth the general economic impact of short-term fluctuations in oil revenues. In the longer run, the fund is a tool for managing these non-renewable natural resources in such a way as to avoid the immediate consumption of temporary revenues, thereby ensuring that the wealth produced by current exploitation is transferred to future generations. The second and more long-term objective enables the allocation of some portfolio assets to investments exposed to higher risk, but that also offer potentially higher returns.

The NGPF was established by a vote of the Norwegian Parliament in 1990. The Fund's inflows are comprised of the net cash flow from petroleum activities (the exact amount is determined annually when the government budget is prepared), plus the return on the fund's invested assets. The Norwegian Ministry of Finance is the manager of the fund, but has delegated responsibility for operational management to Norges Bank, Norway's Central Bank.

The NGPF was designed to serve as an integrated instrument of fiscal policy that renders the use of petroleum revenues totally transparent. In fact, the fund is topped up only if the government is running a global budget surplus, which is why the first transfers to the NGPF did not begin until 1995.

The NGPF's investment guidelines call for a geographic asset allocation strategy, primarily because the Norwegian financial market is too narrow to accommodate risk spread constraints. Thus the fund is only invested abroad. As of December 31, 2003, assets under management totaled 100.6 billion euros. The fund's assets are allocated as follows: 40% equities (50% Europe – 50% Other regions) 60% bonds (35% America – 55% Europe – 10% Asia/Oceania).

The Irish National Pensions Reserve Fund (NPRF)

In light of its currently favorable demographic picture and recent economic track record, Ireland should have at least two decades to prepare for the challenge of meeting the cost of aging. Against this backdrop, the Irish government passed the National Pensions Reserve Fund Act in 1999, and the resulting fund was officially set up in April of 2001. Initially funded with the proceeds of the privatization of Irish Telecom and the sale of UMTS licenses, the NPRF is topped up annually with a sum that is equivalent to one percent of GDP (around 1 billion euros). The Irish Parliament may approve the payment of additional sums from time to time. The NPRF may not be used to help meet the cost of pensions before the year 2025. Fund management has been entrusted for a ten-year period to the National Treasury Management Agency (NTMA), which was originally set up to manage the country's debt.

An independent commission (the National Pensions Reserve Fund Commission) is responsible for controlling, managing and investing fund assets and determining investment strategy. The Commission determines asset allocations and appropriate benchmarks against which the investment return of the NPRF can be assessed, as well as the classes of assets in which it may be invested. The NPRF is not allowed to invest in Irish government securities. Other duties of the Commission include authorizing payments from the NPRF, determining the annual budget for administrative costs charged to the fund, and commissioning independent valuations of fund assets as well as independent assessments of the NPRF's investment performances and forecasts of retirement liabilities.

The NPRF seeks to amass 41 billion euros by 2025, and to top up the fund by an amount equivalent to one percent of GDP starting in 2025, at which time the its assets are expected to represent 36 percent of GDP. As of December 31, 2003, the NPRF had managed assets valued at 9.6 billion euros, of which 80 percent invested in equities and 20 percent invested in bonds.

The FRR: resources and eligible beneficiaries

Established by the Social Security Financing Act for 1999, the FRR originally emerged as a separate accounting section within the French Old Age Solidarity Fund (*Fonds de Solidarité Vieillesse – FSV*).

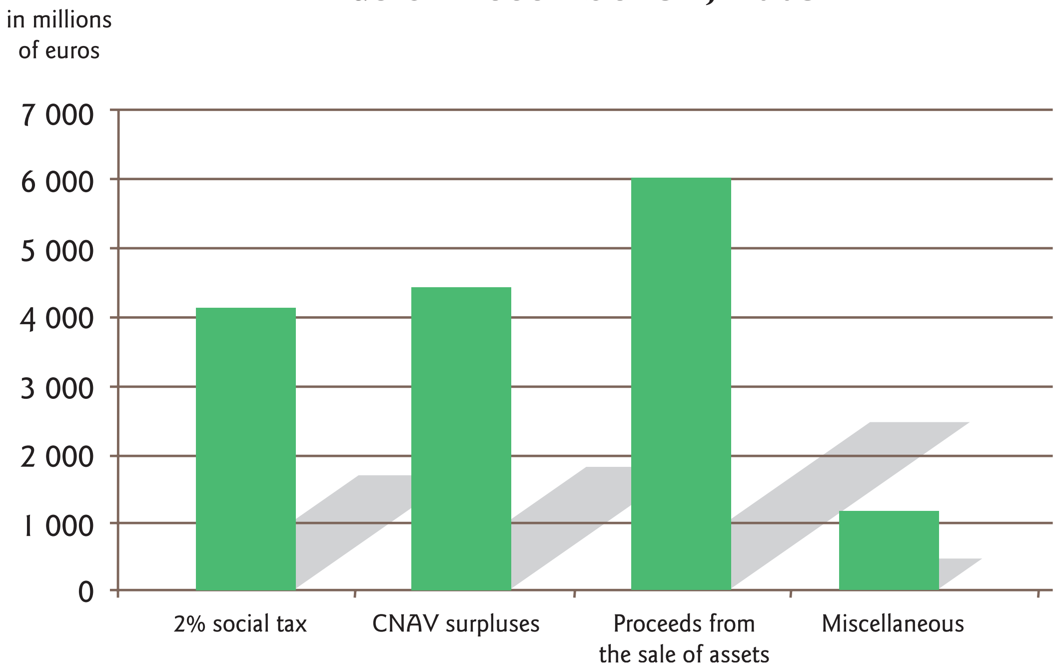
With the Act of July 17, 2001, the FRR became a stand-alone unit. This particular reform was necessary in light of the FRR's stated purpose and the sizeable funds that were entrusted to its management. In a decree issued on December 19, 2001, the FRR acquired its official name (*Fonds de Réserve pour les Retraites*) and its status as a publicly-owned, state-funded administrative agency operating under the dual auspices of the French Minister in charge of Social Security and the French Minister in charge of the Economy and Budget.

The Fund was set up to manage the sums that are allocated to it, setting them aside in a trust until 2020, after which they will be used to contribute to the long-term survival of mandatory old age insurance plans (the general plan, CNAVTS) and aligned plans for salaried farm workers (ORGANIC) and skilled crafts-persons (CANCAVA).

The FRR had reserves totaling 16.45 billion euros on December 31, 2003. By virtue of the aforementioned Act of 2001, it receives a number of different allocations, which may be divided into four broad categories:

- A portion of the 2 percent social tax on income from estates and investments
- Surplus sums from the French National Old Age Fund (*Caisse Nationale d'Assurance Vieillesse – CNAV*)
- Proceeds from the sale of certain state-owned assets (through privatization, the sale of *Caisse d'épargne* units, the sale of UMTS licenses, etc.)
- Miscellaneous endowments and allocations.

Sources of contribution to the FRR accumulated as of December 31, 2003



Fund management and governance

Consistent with its stated purpose and in light of the volumes of funds it manages, the FRR has set up structures of management and government intended to ensure:

- Independence: This spirit is reflected in the Fund's status, as well as in the fact that all reserves are allocated to its sole purpose, which is to consolidate the PAYGO system by 2020.
- Transparency: Due to the nature of the Fund's resources, its strategy and financial statements must be disclosed to the public at regular intervals. The process of awarding management mandates for the Fund's assets is conducted in compliance with official government regulations on public bidding and requests for proposals (RFPs).
- Close involvement of labor and management stakeholders and legislators in the operation of the FRR, via its Supervisory Board.

Management structures

The FRR was the first publicly owned, state-funded agency in France to be governed by an Executive Board and a Supervisory Board. The aim of this form of governance is to ensure that a clear separation is established and maintained between the executive function and that of guidance and control. In a speech delivered on November 27, 2002 during the FRR Supervisory Board's official inauguration ceremony, government minister François Fillon noted: *"Our lawmakers have implemented a mechanism for the Pension Reserves Fund that may be summed up in the following terms: The Executive Board shall be its executive branch, and you shall be its legislative branch."*

From left to right:
Jean-Louis Beffa, Raoul Briet and Jean-Christophe Le Duigou

Hence, Supervisory Board members include actual legislators, labor/management stakeholders, representatives of the ministries under whose general supervision the FRR operates (i.e., the ministries of Social Security and of the Economy, Finance and Industry) and individuals with recognized credentials in fields that are relevant to Fund's stated missions. The Board, which currently counts twenty members, is required to meet a minimum of twice yearly. Since its members took office at year-end 2002, the Board has held six meetings.

Supervisory Board

The Supervisory Board is responsible for:

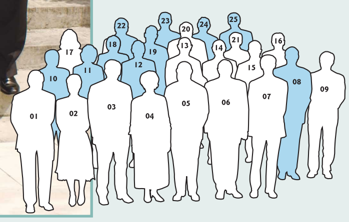
- Defining, on the recommendation of the Executive Board, general investment policy orientations for the Fund's assets, in accordance with the objective and timeframe for use of the Fund's resources, as well as with the prudent man and risk diversification principles;
- Appointing the independent auditors of the Fund;
- Auditing the Fund's performance;
- Approving the Fund's annual financial statements;
- Preparing an annual report on Fund management for public disclosure.

The composition of the Supervisory Board is established by State Council decree. The Board's twenty members are chosen from among:

- *The legislative branch of government (two representatives from the French National Assembly - Assemblée Nationale - and two from the French Senate - Sénat);*
- *Representatives of social security beneficiaries, designated by general labor and trade unions with nationwide scope (five members);*
- *Representatives of employers and self-employed workers, appointed by representative employers' and self-employed workers' unions (five members);*
- *Representatives of the executive branch of government (four members, of which one from the Ministry of the Economy, one from the Ministry of the Budget, and two from the Ministry in charge of Social Security);*
- *Individuals with recognized credentials in fields that are relevant to the FRR's stated missions (two members).*

The chairman of the FRR Supervisory Board is appointed from among its members by decree. Since October 23, 2002, Mr. Raoul Briet has served as chairman of the Board. Mr. Jean Louis Beffa, Chairman and CEO of Saint-Gobain, and Mr. Jean Christophe Le Duigou, Secretary of the trade union CGT, serve as vice-chairmen.

In the diagram below, the Supervisory Board members pictured in the photo are indicated by the color white.



***Members of the Supervisory Board:** 01: Alain Leclair - 02: Isabelle Sancerni - 03: Marc Laffineur - 04: Solange Morgenstern 05: Jean-Jacques Poujade - 06: Jean-Louis Beffa - 07: Raoul Briet - 09: Yves Bur - 13: Jean-Christophe Le Duigou - 14: Bernard Caron 15: Thierry Francq - 16: Jean Bensaïd - 17: Jean-Paul Le Bail - 20: Georges Tissié - 21: Jean-Louis Rey.*
***Members of the Executive Board:** 08: Francis Mayer - 23: Antoine de Salins - 24: Philippe Most.*
***FRR staff members :** 10: Jean-Louis Nakamura - 11: Maria Rucli - 12: Bruno Veccia - 18: Edith Jousseaume.*
***Government Controllers:** 19: Pierre Bertinotti - 22: Guy de Monchy.*
***Director, Caisse des Dépôts et consignations (Direction des retraites):** 25: Jérôme Gallot.*
***Supervisory Board members not pictured here:** Dany Bourdeaux, Adrien Gouteyron, Dominique Leclerc, Guillaume Sarkozy and Pierre Ricordeau.*

The Executive Board is responsible for directing the agency and for ensuring its smooth operation. It executes investment policy guidelines and ensures that they are complied with. The Executive Board reports regularly to the Supervisory Board on its management of the agency, and in particular relates information on the way in which investment policy guidelines take into account social, environmental and ethical considerations. The Executive Board has three members and is chaired by the Chief Executive Officer of the *Caisse des Dépôts et Consignations.*

Executive Board

The Executive Board is responsible for managing the FRR. In particular, its duties include:

- *Drafting the specifications used in RFPs;*
- *Appointing duly qualified individuals to serve on the committee charged with selecting asset managers;*
- *Selecting third-party portfolio management firms to manage Fund assets;*
- *Entering into agreements on behalf of the Fund and monitoring the performance of these agreements;*
- *Preparing the Fund's administrative and investment management budget, and exercising authority over administrative management;*
- *Implementing the FRR's budget;*
- *Submitting the FRR's financial statements to the Supervisory Board for approval;*
- *Recruiting and supervising agency personnel;*
- *Determining the Fund's internal operating policies and procedures (except for those that pertain to the Supervisory Board).*

In implementing measures that it deems necessary to carry out its Fund management duties, the Executive Board may deviate from the latest guidelines set forth by the Supervisory Board, if circumstances so warrant and if doing so is intended to reduce the exposure of Fund investments. The Executive Board informs the Supervisory Board of any measures taken with this intent.

From left to right:
Philippe Most, Francis Mayer and Antoine de Salins

Control mechanisms

The FRR has a designated accounting officer, who is responsible for Fund accounting, including the maintenance of accounting records and all relevant supporting documents and vouchers. Acting on instructions from the officer responsible for authorizing appropriations, the accounting officer is responsible for recording Fund revenue and appropriations. At the end of each fiscal year, he draws up an annual financial report, which is submitted to an audit by the government financial comptroller, as well as the French Government Audit Office (*Cour des Comptes*), the French Tax Inspectorate (*Inspection Générale des Finances*) and the Social Security Inspectorate.

In addition, two independent auditors are assigned the task of certifying that the descriptions and valuations of the Fund's assets are accurately presented in the semi-annual statements prepared by the Executive Board and submitted to the Supervisory Board.

Following a bidding process that was conducted at year-end 2003 in accordance with the procedures governing negotiated contracts, in March of 2004 the Supervisory Board appointed two accounting firms to serve as the FRR's independent accountants for a six-year term.

These firms have also been commissioned to assist the FRR accounting sub-committee, chaired by Jean Louis Beffa, one of the two vice-chairmen of the Supervisory Board.

This sub-committee, established in accordance with the Fund's internal operating policies and procedures, is responsible for preparing the Supervisory Board's proceedings on the approval of the annual financial statements. It also assists the Board in its review and audit of these disclosures. The accounting sub-committee was formed in July of 2003 and participated in the process of selecting independent accountants for the FRR.

Personal and professional code of conduct and ethics

After ratification by the Supervisory Board and the Executive Board, respectively, the FRR's supervising ministries approved the Fund's internal policies and procedures on June 25, 2003. Requirements that apply to the Fund's structures of governance include the following:

- When members of the Executive Board take office, they must submit a statement to the Supervisory Board indicating the interests and positions they hold in outside economic and financial concerns, as well as any corporate directorships and offices they hold. This information is also made available to other members of the Executive Board. Information on positions and offices held is continuously updated, and other information is updated at the beginning of each six-month period of the year.

- As for the actual financial or investment management of the FRR, members of its Executive Board are barred from reviewing and voting on matters involving parties in which they hold a position, office or interest (as provided for in Article L135-13 of the Social Security Code (*Code de la Sécurité Sociale*). Nor may Board members participate in reviews or decisions pertaining to matters in which they (or a corporation in which they perform professional duties or hold an office) have represented one of the interested parties in the course of the eighteen months preceding such deliberation. Members examine the items of business on the agenda of each Executive Board meeting, judging for themselves whether their situation or relationship with an organization to which they are affiliated as described bars them from participating in the related review and/or decision-making process, notifying in writing the chairman of the Supervisory Board and fellow members of the Executive Board. This principle was invoked, for example, in connection with the process for selecting asset managers for Fund investments.

- Like everyone in the employ of the FRR (the "Associates"), members of the Executive Board are held to a strict obligation of non-disclosure, as defined and subject to the penalties set forth in Articles 226-13 and 226-14 of the French Criminal Code (*Code Pénal*). Experts and other outside advisors and consultants are held to the same obligation of non-disclosure, subject to the same penalties for non-compliance.

After having consulted with the chairman of the Supervisory Board, the Executive Board decided in July of 2003 to adopt a number of guidelines for professional and personal conduct to which all Associates reporting to the FRR Executive Board are subject. In particular, these guidelines specify their legal and professional obligations (integrity and loyalty in the performance of professional duties, disclosure of suspicious transactions) and those pertaining to control and supervision (conformity of decisions with legal and regulatory requirements, as well as with FRR policies and procedures; full cooperation with controllers and auditors).

FRR Associates are held to an obligation of discretion and probity, and must refrain from using their affiliation with the Fund for personal gain or ends. All FRR Associates agree to refrain from accepting any outside consulting or other work (with the exception of purely private activities that involve affiliation with philanthropic or other organizations, including trade unions, or elected office) without obtaining the Fund's prior consent in writing.

All Associates are required to avoid situations where their personal interests conflict with the interests of the FRR. They may not be personally involved in a transaction, negotiation or contract on behalf or in the name of the Fund, with an outside entity in which they or a close relative have a direct or indirect interest, without having fully informing the FRR of such relationship in writing and without having obtained the FRR's prior consent in writing. The Executive Board is responsible for ensuring compliance with these guidelines.

Organized consultation

Pursuant to legislation governing the FRR, in July of 2003 the Fund formed a manager selection committee to assist the Executive Board in the task of screening investment firms being considered for asset management mandates.

The Manager Selection Committee is fully independent and examines management applicants with due care and diligence. Its members are subject to ethical guidelines that are consistent with their duties.

From left to right:
Antoine de Salins, Alain Robidel, René Karsenti, Alain Hindié and Christopher Nowakowski

Manager Selection Committee

Article R 135-27 of the French Social Security Code provides for the formation of a Manager Selection Committee (MSC), charged with opening and analyzing the proposals submitted by asset management firms competing for FRR mandates. In addition, the Executive Board consults with the Committee on specifications for these RFPs, and reports on the performance of the mandates referred to in this article.

The MSC is composed of a chairman and four individuals with the requisite professional credentials, who are appointed by the Executive Board. The chairman of the Manager Selection Committee is chosen from among the members of the FRR Executive Board other than its chairman.

The MSC's current members are:

- *Alain Hindié, former member of the Executive Committee of Crédit Lyonnais and former head of its asset management division;*
- *René Karsenti, director general of finance for the European Investment Bank;*
- *Christopher Nowakowski, a Canadian national, former international consultant for global asset management selection;*
- *Alain Robidel, former chief financial officer of the Mederic group, a pension fund institution.*

The Manager Selection Committee began operating on July 2, 2003. Its current chairman is Antoine de Salins, a member of the FRR Executive Board.

Financial strategy

Defining investment strategy

Stating a collective preference

Like any investor, the FRR's strategic asset allocation is determined on the basis of the Fund's defining characteristics:

- **Investment horizon and nature of liabilities**: The volatility of asset returns generally diminishes as the investment horizon lengthens, because the events that cause short-term fluctuations tend to be counterbalanced over time. Economic cycles work in much the same way. The investment time horizon of the Fund is, by definition, long term, as no payouts will be made before 2020. Moreover, unlike many other French or foreign pension funds, the FRR is a pure accumulation fund, which means that it does not carry future pension payments as liabilities and hence does not have to match them with assets that, while liquid, provide low returns. Thanks to this enviable position, the Fund can increase its allocations to securities whose returns are more volatile over the short term.

- **Ability to adjust investment policy**: Regular inflows to the Fund should make it possible to reduce the portfolio's global volatility. This in turn allows the Fund – without altering the risk objective – to proportionately increase the amount invested in assets that exhibit higher volatility over the short term. In fact, extremely prudential assumptions were used to determine these allocations, so that the perceived ability of the Fund and its managers to smooth out asset purchase prices and, in so doing, reduce the global investment risk, would not be artificially favorable and hence distorted.

- **Degree of risk aversion**: Naturally, this parameter is critical. Before making any decisions, every investor has to be able to identify his or her personal risk-reward tradeoffs. In the case of the FRR, this characteristic was all the more difficult to capture given that these preferences are collective rather than personal, ascribable to the beneficiaries of all eligible plans whose members may receive payouts from the Fund after 2020. As provided for in applicable legislation, it was therefore the prerogative of the Supervisory Board – whose members include representatives of the legislative branch of government, of labor and management, and of the Fund's supervising ministries – to express this collective risk aversion within the framework of its written "general investment policy orientations." This particular risk tolerance profile could have been expressed in various ways (minimum return objective, maximum probability of not achieving a minimum return, a cap on acceptable losses over rolling horizons, etc.). The Supervisory Board unanimously decided to refrain from introducing maximum loss constraints over the short term, in order to enable the FRR to fully leverage the advantage implicit in its very long-term investment horizon (see above). In return, the Board decided to require that all asset allocations be calculated with the aim of achieving virtually zero probability of capital losses at the 2020 investment horizon.

Transparent optimization method

Once these parameters had been set, the Fund's internal experts began the process of making the calculations needed to determine the FRR's initial, optimal strategic allocation. The Supervisory Board's role at this stage was to check the assumptions and methods on which calculations were based. In this way, contrary to conventional asset allocation models, which are based on past observation, and which tend to be favorable to equities over the long run, the decision was made to model allocation on a macro-economic and financial scenario that integrated the potential impact of core projections – a declining number of active workers, demographic aging, and structural changes in economic or capital markets – on potential growth, inflation levels and demand for securities. The resulting hypotheses are particularly conservative with respect to the risk premiums assigned to equity securities versus debt securities.

These hypotheses were formulated from an investment universe that includes publicly traded equities, bonds issued by sovereign and corporate borrowers, and bonds indexed to inflation whose issuers fall within the eurozone or other developed regions or markets. Indeed, the Supervisory Board's original intent was to ensure that the FRR's investment portfolio was positioned to leverage the benefits of international diversification in terms of cycle and/or economic policy decorrelation, as well as in terms of the additional returns expected for certain securities, in particular equity securities issued by businesses operating in the world's most dynamic regions from a demographic perspective.

The prudential constraints to which the FRR is subject

Amended Decree No. 2001-1214, dated December 19, 2001, sets forth the investment constraints to which the FRR is subject. The Fund may not invest:

- More than 5% of its assets in financial instruments issued by a single issuer, with the exception of:
  a) Financial instruments issued or secured by a Member State of the European Community or party to the European Economic Area Agreement or by the *Caisse d'Amortissement de la Dette Sociale (CADES)*;
  b) Units or shares in investment firms whose portfolio is exclusively made up of the financial instruments referred to in item a;

- More than 25% of its assets in stock or securities with a claim to the equity capital of companies headquartered outside of the European Economic Area, or not traded on a regulated market of a party to the European Economic Area Agreement, or on a regularly operating market of a third country that is a member of the Organization for Economic Co-operation and Development; the jurisdictional authorities of this third country must have specified the conditions of operation, access and admission to trading and ensure compliance with disclosure and transparency requirements;

- More than 3% in shares or equity issued by a single issuer.

The Fund may conclude futures contracts under the same conditions that apply to futures contracts entered into by mutual funds, as set forth in Decree No. 89-623 and Decree No. 89-624 of September 6, 1989. However, the credit exposure limit for any single counterparty is set at 5% of the Fund's total assets. Finally, foreign exchange exposure may not exceed 20% of the Fund's total assets.

Naturally, the limits set forth in the Fund's founding texts – in particular, those pertaining to the portfolio's acceptable level of international exposure – were factored into these optimal allocation calculations. For example, the FRR may not invest more than 25% of its assets in equities or other securities with a claim to equity capital issued by companies based outside the European Economic Area or in private equity (unlisted securities). Similarly, exposure to exchange rate fluctuations cannot exceed 20% of the Fund's total assets.

A highly diversified strategic allocation

Acting on the recommendations of the Executive Board in general, and based on the results of its optimal asset allocation in particular, the Supervisory Board unanimously approved the following items on April 2, 2003:

- A list of asset classes eligible for inclusion in the FRR's initial request for proposals from asset managers (see inset below):

List of admissible asset classes for the FRR's initial RFP

1 – Eurozone monetary instruments: Negotiable debt securities and money market funds denominated in euros.

2 – Eurozone listed equities: Stocks quoted in euros and issued by companies whose registered head office is located in one of the countries in the European Economic Area. These include large caps (currently defined as stocks of companies whose market capitalization exceeds 3 billion euros) and mid-caps (currently defined as stocks of companies whose market capitalization ranges from 500 million euros to 3 billion euros).

3 – Eurozone issues of sovereign and quasi-sovereign bonds (government bonds listed or quoted on a regulated market of the eurozone, whose face value is denominated in euros), including bonds indexed to French or eurozone inflation.

4 – Non-sovereign bonds from eurozone issuers whose long-term credit rating falls within the acceptable investment-grade range (at least BBB- for Standard and Poor's and Fitch; Baa3 for Moody's). [(a)]

5 – Listed international equities from Europe outside the eurozone, North America, Asia (excluding Japan) and Japan

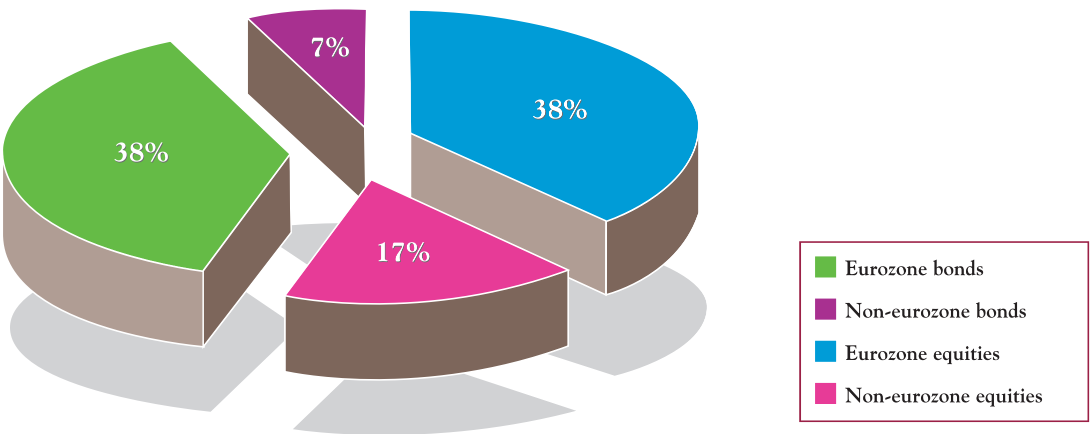
6 – International sovereign bonds from issuers in Europe outside the eurozone, North America and Japan. Bonds issued by the governments of emerging nations are excluded from the initial request for proposal.

7 - Non-sovereign international bonds from issuers in North America and Europe outside the eurozone whose long-term credit rating is investment grade (rating of at least BBB- for Standard and Poor's and Fitch or Baa3 for Moody's). [(b)]

8 - Private equities including unlisted equities, shares of FCPR/FCPI (French venture capital/innovation funds), and shares of unlisted property unit trusts or partnerships.

(a) High yield bonds from issuers whose long-term credit rating falls within the below investment grade or junk bond category are excluded from the initial RFP.
(b) High yield bonds from issuers outside the eurozone whose long-term credit rating falls within the below investment grade or junk bond category are excluded from the initial RFP.

- A strategic allocation among the principal asset classes that meets the following distribution requirement:



This distribution among the major asset classes provides only an imperfect measurement of the exact percentage of the allocation that is devoted to corporate equity (stocks) or debt (corporate bonds) financing. In fact, of the 38% of total assets allocated to eurozone bonds, nearly 10% will be invested in corporate bonds (thus the relative weight of this asset class in the portfolio is significantly higher than the actual weight of the underlying market segment). Nearly half of all bond investments outside the eurozone will be in corporate bonds. If the Fund's total equity investments (55%) are taken into account, then it can reasonably be argued that more than two-thirds of the Fund's strategic allocation is devoted to the long-term financing of corporate investments. Consequently, the Fund participates actively in enhancing the growth prospects and productivity levels of businesses, and ultimately in raising standards of living.

The Fund's investment philosophy is summed up in the Supervisory Board's general investment policy orientations, a statement that met with the unanimous approval of its members at their meeting of April 2, 2003. The statement is reproduced in full below.

Wording of the Resolution on the general investment policy orientations of the Fund

In light of the recommendations submitted by the Executive Board to the Supervisory Board at meetings held on March 5 and April 2, 2003, and

Whereas the objective of the FRR is to contribute to the future financing of eligible pay-as-you-go pension plans; and whereas the reserves accumulated by the Fund until the year 2020 shall be used in particular to smooth out the expected impact of anticipated demographic trends on the financing needs of these plans over this time horizon;

Whereas the FRR has a long-term investment horizon, and the Supervisory Board reaffirms its commitment to 2020, the year in which, pursuant to the French Act of 17 July 2001, the Fund may be drawn from to help finance eligible mandatory pension plans; whereas the scheduled interval of payouts is a key factor in determining investment policy, in light of which the Supervisory Board accepted the technical hypothesis used by the Executive Board (i.e., a straight-line payout plan over the ten years following 2020) while maintaining that a longer payout hypothesis, extending over twenty years, may be appropriate; and furthermore, whereas a long-term strategy for regular additional payments to the Fund is required to enable the adaptation of investment policy under the best possible conditions;

Whereas the FRR's investment policy aim is to optimize investment returns by 2020 while ensuring the best possible conditions of security and compliance with the risk constraints indicated below; and whereas the Fund will contribute to financing economic agents, especially businesses, thereby enhancing their long-term growth prospects, the sustainable creation of wealth and the expansion of employment;

Whereas the FRR acts in the interest of the community, and for this reason must adhere to an investment policy that is consistent with communal values that promote balanced economic, social and environmental development; whereas, for this reason, and acting within the broad confines of the investment policy drawn up by the Supervisory Board, the Executive Board shall actively seek to promote best practices aimed at encouraging asset managers to respect these values in their financial analysis and in the transparency of corporate governance; whereas furthermore, with respect to this last point, the French Decree of December 19, 2001 stipulates that proxy voting rights shall be exercised by the

Fund in the sole interest of the Fund, and the Fund intends to set forth a set of guidelines incumbent on asset managers acting as proxies for the Fund at general shareholders meetings of companies in which the Fund is invested; and whereas, like certain foreign reserve funds, the Fund may invest in mutual funds specialized in various forms of socially responsible investment, the Supervisory Board being particularly attentive to regular reporting from the Executive Board on its efforts to incorporate these values into the Fund's investment policy;

Whereas the Supervisory Board is responsible for defining the broad outlines of investment policy, which must indicate strategic allocations to the principal categories of financial instruments in line with the Fund's stated objectives and characteristics; whereas these guidelines are intended to evolve over time as the FRR's investment horizon changes; whereas, moreover, they may be revised on the recommendation of the Executive Board if new assets are admitted to the Fund's investment portfolio or if the principal hypotheses on which these guidelines were formulated are subject to revision; whereas the Fund's investment policy shall maintain a certain margin of flexibility with respect to the target strategic allocation set by the Supervisory Board, to accommodate market fluctuations and short-term expectations of economic and financial market trends; whereas it is incumbent on the Executive Board, especially in connection with the definition of management mandates, to determine the way in which this margin of flexibility shall be exercised by itself and by the asset managers acting on behalf of the FRR; and whereas the Executive Board shall submit regular reports to the Supervisory Board explaining how this margin of flexibility has been used;

Whereas the Executive Board's recommendations on asset allocation are founded on the need to limit the likelihood of a nominal capital loss over the Fund's investment horizon; and whereas the objective (which is shared by the Supervisory Board) of optimizing the long-term return does not preclude the possibility of significant short-term fluctuations in the net asset value of the FRR's portfolio;

Whereas, in building its recommended strategic asset allocation, the Executive Board adopted a financial and macro-economic model that was not based solely on observed past returns, and that also incorporates the possible consequences of demographic aging on macro-economic and financial market trends in industrialized countries; and whereas the Supervisory Board shares this approach;

Whereas the FRR is allowed by law to invest a portion of its assets in securities issued or traded outside the eurozone, that applicable regulations limit the FRR's investment in equities issued by companies headquartered outside the European Economic Area to 25%, that these same regulations also limit the portfolio's exposure to exchange rates to 20%, and that the dual aim of investing outside the eurozone is to minimize risk through optimal portfolio diversification and achieve higher financial returns in geographic regions that are less likely to feel the macro-economic impacts of the demographic aging process over the long term;

The Supervisory Board sets forth the following general investment policy orientations for the FRR:

The Supervisory Board approves the list of assets that may be included in the FRR's initial request for proposal, as appended to this Resolution. Furthermore, acting on the recommendation of the Executive Board, the Supervisory Board may amend this list at future meetings.

Via the asset managers it selects through the RFP process, the Executive Board may gradually invest the Fund's reserves in the principal asset classes, in line with market conditions and based on the following target allocations:

Financial instrument	*Target strategie allocation*
Total equities	***55 %***
Eurozone equities	*38 %*
International equities	*17 %*
Total bonds	***45 %***
Eurozone bonds	*38 %*
International bonds	*7 %*
Total	***100 %***

The Supervisory Board duly notes that the allocation of international assets by geographic region shall take into account the relative weight of these markets in the total market capitalization of the respective assets outside the eurozone.

This investment allocation is a medium-term benchmark. Acting on the recommendation of the Executive Board, the Supervisory Board may move to change it.

To ensure efficient tactical management of the Fund, the Executive Board shall maintain a certain margin of flexibility with respect to the Supervisory Board's target investment allocation. At the next meeting of the Supervisory Board, the Executive Board shall present its recommended definition of this margin of flexibility. In addition, it shall inform the Supervisory Board of the procedures governing the use of this margin of flexibility, in particular as expressed in the management methods set forth in the RFP specifications.

The Executive Board shall also inform the Supervisory Board of the guidelines it intends to require asset management firms to use in the exercise of their proxy voting rights at shareholders' meetings. These guidelines shall be contained in the specifications.

The Executive Board shall report regularly, and at least once every six months, on the implementation and outcomes of this investment policy in general, and on the Fund's asset allocation in particular.

This Resolution shall be made public

Once these orientations were defined, work related to structuring the FRR's portfolio was completed – a vital prerequisite to soliciting and considering proposals from the asset management specialists that will be mandated to manage Fund assets.

Structure of the FRR portfolio and tactical flexibility with respect to strategic allocation

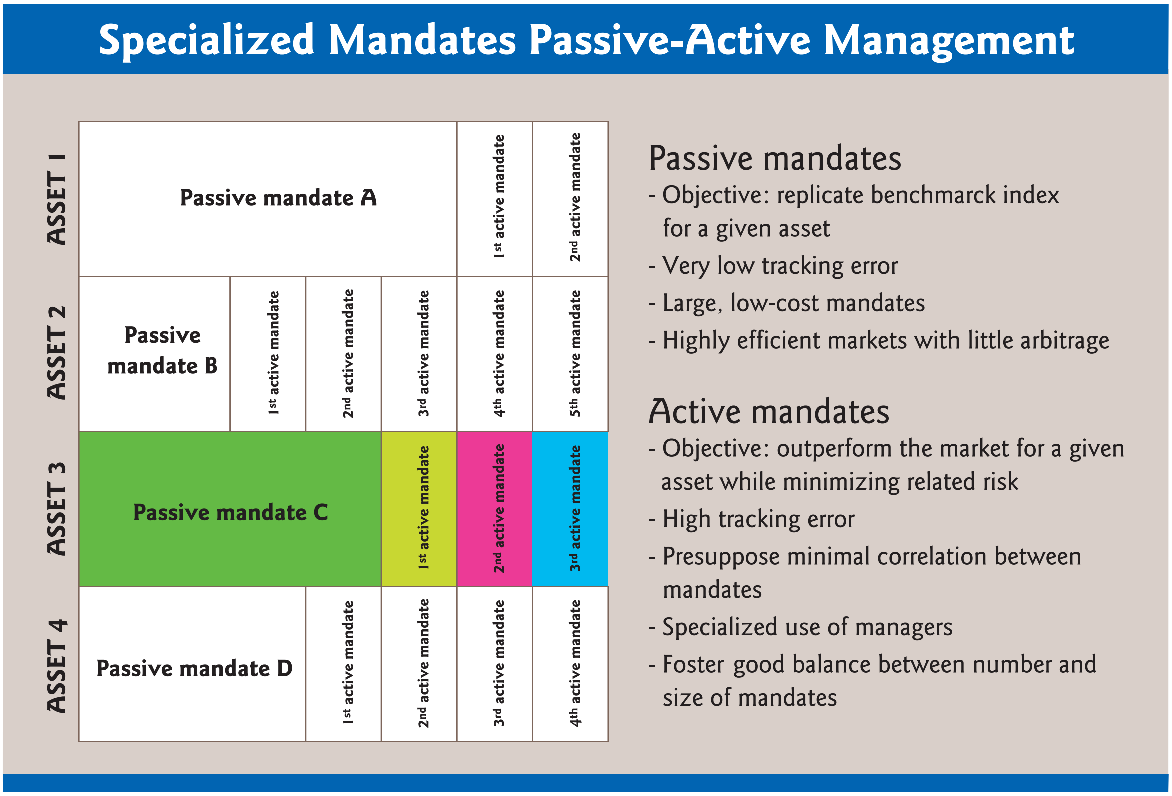
A portfolio based on specialized management mandates, predominantly active

The Fund's expert teams designed the FRR portfolio's target architecture and distributed margins of flexibility among the various types of mandates under consideration on the basis of their examination of each of the following issues, in the order presented below:

- **Specialized versus diversified management mandates.** The Executive Board's target architecture features mandates specialized by classes and sub-classes of diversified assets rather than diversified. This structure favors the selection of managers whose investment processes for specific asset classes have compiled a substantial track record. By allowing for customized mandates, it also promotes the diversification of management styles and inter-class asset arbitrage options. Ultimately, the Fund's investment policy should be easier to decipher.

- **Active versus passive management.** The decision was made to give preference to an active management style, particularly in markets considered to be less efficient, where these inefficiencies can be used to create value by selecting asset class weightings that diverge significantly from the benchmark indices. Nevertheless, to safeguard against the danger that the increased degree of freedom that this type of management entails will expose the entire portfolio to an unacceptable level of risk, several large passive mandates that replicate the performance of their benchmark have been put in place. These mandates offer a low-cost way to leverage market trends while limiting the risk that the portfolio's global performance will deviate too substantially from the market trend.

Consequently, the architecture of the FRR portfolio meets the following three organizational principles: for the most part, the portfolio juxtaposes the major asset classes, with benchmark management mandates covering highly arbitrated markets (typically equity markets, eurozone and US large caps), and specialized active management mandates for more specific and less highly arbitrated sub-compartments (also equity markets, but specialized in small or mid caps, or particular management styles). Roughly 75 percent of the portfolio's assets are managed actively, while the remaining 25 percent are managed passively (a style that is generally known as indexing). A theoretical example of the characteristics of this type of structure is provided below:



For the mandates falling within the scope of the initial request for proposals, specifications were defined with the dual aim of offering asset management firms the option of arbitrating between sub-classes of assets (i.e., between sovereign issues and different credit categories for bond mandates) while limiting the overlap between mandates insofar as possible by ensuring that the same asset class could not be transacted under different types of mandates (with the exception of eurozone large caps, which are included in the investment universes of both active and passive mandates).

This decision responds to a twofold objective: increasing the transparency of the investment strategy while reducing the correlation between the various types of mandates, thereby limiting the portfolio's global risk relative to that of its strategic allocation.

The overall structure of the portfolio that served as the basis for the initial request for proposals is summarized in the table below:

Strategic asset classes	Strategic weights	Categories of assets	Active or passive management	Number of managers (+ standby)	Indicative amounts (EUR M)
EURO ZONE EQUITIES	38%	Large capitalization Eurozone equities	passive passive passive	3 (+1)	1 000 1 000 1 000
		Small and mid capitalization Eurozone equities	active active active	3 (+1)	200 200 200
		Large capitalization Eurozone	active active active active	4 (+1)	620 620 620 620
NON EURO ZONE EQUITIES	17%	Large capitalization US equities	passive	1 (+1)	640
		Mid capitalization US equities	active	1 (+1)	200
		Large capitalization US "value" equities	active	1 (+1)	460
		Large capitalization US "growth" equities	active	1 (+1)	460
		Pan-European equity excluding Eurozone	active active	2 (+1)	240 240
		Pacific-area equities, including Japan, excluding emerging countries	active active	2 (+1)	240 240
EURO ZONE BONDS	38%	Bonds in Euros, government and non-government (investment grade)	active active active active active active	6 (+1)	960 960 960 960 960 960
		Inflation-linked international bonds (2/3 EMU and 1/3 non-Euro international)	active	1 (+1)	480
NON-EUROZONE BONDS	7%	International non-Euro bonds, government and non-government (investment grade)	active	2 (+1)	480 480
	100%			27 (+12)	16,000

Management benchmarks and margins of flexibility

Each specialized mandate is assigned a benchmark and a margin of flexibility, which allows the manager to pick securities from outside the designated benchmark, or to weight the selection on the basis of personal convictions. For passive management mandates, this margin of flexibility is, by definition, extremely narrow, since the manager's objective is to replicate the performance of the index. Conversely, active investment mandates give managers greater flexibility so that they can attempt to beat their market in terms of performance.

Benchmark indices and tracking errors

The FRR has chosen the FTSE group, a global leader in the production of indices, to provide eight benchmarks to track the management of its equity mandates for Europe, America and Asia. This range tracks the equivalent of 8.8 billion euros in assets, which belong to the new e FTSE Global Equity Index Series (GEIS). For bond indices, FRR uses iBOXX, Barclays Capital and Lehman Brothers to define composite indices adapted to the type of management mandate delegated. These customized indices also take into account the tax status of the FRR.

Asset class	Index	Tracking error
Lot 1 – Eurozone large caps, passive management	FTSE Eurobloc Large Cap Index	0.5%
Lot 2 – Eurozone small and mid caps, active management	FTSE Eurobloc Mid & Small Cap Index	10%
Lot 3 – Eurozone large caps, active management	FTSE Eurobloc Large Cap Index	5%
Lot 4 – US large caps, passive management	FTSE USA Large Cap Index	0.5%
Lot 5 – US mid caps, active management	FTSE USA Mid Cap Index	8%
Lot 6 – US large caps, active value management style	FTSE USA Value Large Cap Index	7%
Lot 7 – US large caps, active growth management style	FTSE USA Growth Large Cap Index	10%
Lot 8 – Europe ex-eurozone large caps, active management	FTSE Developed Europe ex-Eurobloc Index	5%
Lot 9 – Pacific Rim large caps, active management	FTSE Developed Asia Pacific Large Cap Index	8%
Lot 10 – Eurozone bonds, sovereign and credit, active management	iBOXX Composite Euro Indices	2%
Lot 11 – International bonds indexed to inflation, active management	Composite Inflation-Linked Bonds Index Barclays Capital	1.5%
Lot 12 – International bonds ex-eurozone, active management	Global Aggregate Index Lehman Brothers	2%

Naturally, the hope of greater return is not without risk. By moving away from the composition of the benchmark index, the active manager can outperform as well as underperform. The margin of flexibility accorded will be measured concretely in terms of where the tracking error – positive or negative – may lie with respect to the index, based on standard statistical distribution. This tracking error is calibrated on the basis of mandate type, particularly in terms of the additional return that can reasonably be expected given the additional risk assumed.

As an illustration, significant margins of flexibility are given to managers for small and mid caps and Asian equities. Conversely, the margin is narrower for European large caps, since individual manager performance versus the market is also traditionally much narrower.

The following table lists the benchmark indices and tracking errors granted to managers for each asset class.

Management of the strategic allocation and tactical tradeoffs

The decision to structure the portfolio around specialized management mandates left an important question unanswered: how would gaps between the "real" weights of the principal asset classes and their target weights in the strategic allocation be managed? Due to fluctuations in their valuation or a deliberate underweight or overweight, the principal asset classes will in fact rapidly deviate from their target weight as defined in the investment policy orientations. Tactical asset allocation consists of deciding to what extent these deviations should be maintained, whether to increase them if the overweight assets are expected to continue to outperform the underweight assets or, on the contrary, to eliminate the deviations and strictly adhere to the strategic allocation.

The Supervisory Board authorized the Executive Board to manage this tactical asset allocation in two possible ways. First, by distributing new sums paid into the Fund among the management mandates, with preference given to the asset classes that show the most favorable return potential over a short- or medium-term time horizon. Second, by awarding an "overlay" mandate to an asset manager specializing in tactical allocation, which covers all the mandates for the specific asset classes.

This manager will adjust the portfolio's exposure to the principal asset classes, as determined by the Executive Board, using regulated derivatives linked to the principal indexes. The leeway granted to the Executive Board to overweight or underweight the principal asset classes with respect to the targets was symmetrically defined so that, assuming normal volatility, the equity assets in the Fund's portfolio represent 49 to 61% of the fund's total assets (6 percentage points above or below the target weight of 55%).

Socially responsible investment: approach and aims of the FRR

General philosophy

The FRR seeks to generate the best possible returns from the assets entrusted to its care while benefiting from optimal levels of financial security. Applicable legislation does not include a particular set of SRI guidelines for FRR management. The FRR Executive Board was simply asked to submit an annual report to the Supervisory Board indicating how "*these issues are reflected in the management of the Fund's assets.*"

More explicit guidance can be found in the Supervisory Board's April 2, 2003 proceedings on general investment policy orientations: "*The investment policy must also be consistent with certain shared values that promote economically, socially and environmentally sustainable development.*" In addition, "*The Executive Board will actively contribute to promoting best practices, thereby encouraging asset management firms to incorporate these values into their analysis of financial assets and corporate governance transparency.*"

In light of the foregoing, it is clear that the FRR – a long-term investor whose very purpose is to support inter-generational solidarity – firmly believes that broadening the scope of risk analysis to encompass social and environmental factors has a positive impact on financial performance, in the same way that building long-term value creation on the foundations of best practices in human resources, environmental awareness and corporate governance does.

The Fund's Supervisory Board set forth certain guidelines for the Executive Board that relate more specifically to corporate governance practices (see attached copy of the proceedings), in line with the progressive shift toward an active exercise of proxy voting for the companies in which the FRR will invest. By the end of 2004, the Executive Board will submit a draft set of proxy voting guidelines to the Supervisory Board.

Approach to SRI

Scope of application

If the option of excluding certain sectors – something the FRR does not wish to do – is ruled out, implementing SRI objectives is a complex task. Socially responsible fund management practices are heterogeneous and lack sufficient maturity. In particular, they are directly dependent on the quality, quantity and relevance of the sources of information available on a company's social and environmental policies and performance. For certain geographical regions or asset classes, these sources are currently too limited to support the development of a full-fledged market for socially responsible asset management products and services.

This is why the FRR has decided to concentrate its "socially responsible" approach on *Eurozone and non-euro Europe large cap equities mandates* (see lots 3 and 8 of the attached portfolio structure), which represent a total of just under 3 billion euros, approximately 18% of the Fund's total assets as of mid 2004. This does not rule out the option of extending this approach to a broader universe in the medium run, after the FRR's initial management mandates have expired (in 3 to 5 years, depending on the lot). Possibilities would include Asian large caps, Eurozone small and mid caps, US mid caps, and US value/growth stocks, as well as fixed-income mandates.

Exercising the FRR's proxy voting rights

In its April 2, 2003 Resolution on the Fund's general investment orientations, the Supervisory Board stated its desire that the FRR be actively involved in promoting good corporate governance practices in the companies in which the Fund may invest, insofar as these practices promote long-term growth and create value.

The Board also stated that the Fund would set forth the guidelines that asset managers would be expected to follow in the exercise of proxy voting rights at shareholders' meetings, in accordance with the FRR's founding texts.

The Fund does not intend to use its influence as a shareholder to acquire representation on the boards of the companies in which it invests. Nevertheless, the Fund should aim to consistently exercise its right to vote at annual shareholders' meetings. By definition, this right to vote is an obligation, which is built over time and pragmatically, taking into account the conditions under which any particular vote is exercised, as the experience of comparable foreign funds demonstrates, and also the diversity of legal frameworks and corporate governance practices around the world.

In accordance with the French Decree of December 19, 2001, the positions adopted in the name of the FRR are dictated only by the Fund's interests and taken in the strictest independence. It is the Executive Board's responsibility to ensure compliance with these requirements and submit timely reports on this issue to the Supervisory Board.

As a responsible, long-term investor, the FRR seeks to take into account the long-term interests of the companies in which it invests and all relevant stakeholders, as well as the coherency of underlying corporate strategy. Consequently, the FRR will naturally incorporate regulatory requirements in force and company codes of conduct into the investment guidelines it develops for the asset management firms to which it awards mandates. This remark pertains in particular to corporate practice in terms of disclosure, board composition and independence, and equal treatment of shareholders.

The Supervisory Board hoped that the process of selecting asset managers would serve as an opportunity for aspiring applicants to indicate how they intended to ensure that the FRR would be able to exercise its voting rights efficiently. By the end of 2004, the Executive Board will provide the Supervisory Board with a statement of the Fund's corporate governance policy and related practical measures pertaining to asset managers. The Executive Board will also provide the Supervisory Board with an annual report that explains the procedures and outcomes of proxy voting.

Manager commitments

The preferred approach is both gradual and inclusive. The FRR did not want to establish a fixed set of SRI criteria from the outset, applicable to all companies in its portfolios, without engaging in genuine consultation beforehand. This would have been neither professional – in terms of the technical quality that would have resulted given the relative immaturity of SRI strategies and the real difficulty of these questions – nor realistic – considering that the FRR had to be ready to launch the management mandates as rapidly as possible. Under the circumstances, it seemed more reasonable to adopt a collective and collaborative approach, whereby the Fund's SRI guidelines would gradually be defined with the help of asset managers selected, on the basis of the latter's methods, allocations and performances – without neglecting all other stakeholders in the process.

This is why the questionnaires sent to potential managers and the requests for proposal (RFP) for lots 3 and 8 are open not only to all existing SRI approaches, but also to managers with no track record in SRI management per se, but who have expressed the desire to collaborate with the FRR in this area. At the same time, the RFP specifies four commitments that managers must be willing to make:

• ***Research and analysis***

Subject to the availability of data, the FRR requests that asset management firms seek out and analyze relevant and reliable information on the social and environmental behavior and practices of companies being considered for investment (through analysis of published materials, contact with companies, internal research, special rating agencies, etc.).

The aim of this analysis is twofold: first, to include this information in the stock-picking process (see next commitment) and second, to broaden and deepen knowledge of these companies, so that the most appropriate and useful extra-financial future performance indicators can be identified.

• ***Consideration of extra-financial criteria***

Using the results of this research and analysis, the FRR requests that asset management firms gradually incorporate extra-financial criteria into their stock-picking process (if they are not already doing so) and that, in doing so, they use generally accepted international guidelines. They may establish their own guidelines or benchmarks or – as a bare minimum – simply refer to the nine principles set out in the UN Global Compact (see the following inset). Management firms may choose to integrate these criteria into the management process more or less gradually, as long as they tend toward the establishment of a serious SRI management policy. Moreover, the mandate's stated risk tolerance level and management objectives must be respected throughout this gradual integration process.

Nine principles of the UN's Global Compact

Human Rights: *Businesses are asked to*

Principle 1: Support and respect the protection of international human rights within their sphere of influence

Principle 2: Make sure their own corporations are not complicit in human rights abuses

Labor: *Businesses are asked to uphold*

Principle 3: The right to freedom of association and the effective recognition of the right of collective bargaining

Principle 4: The elimination of all forms of forced and compulsory labor

Principle 5: The effective abolition of child labor

Principle 6: The elimination of discrimination in respect of employment and occupation

Environment: *Businesses are asked to*

Principle 7: Support a precautionary approach to environmental challenges

Principle 8: Undertake initiatives to promote greater environmental responsibility

Principle 9: Encourage the development and diffusion of environmentally friendly technologies.

• *Transparency*

The FRR requests that management firms disclose how they have integrated extra-financial criteria into their management process and the impact of the SRI filters they have used on the portfolio (composition, performance, risk, etc.).

• *Exchange with the FRR*

Managers who are awarded mandates by the FRR are expected to share the information they acquire on companies, and to disclose both how they implement their methods and their track record as managers, so that the FRR can eventually build its own benchmark and method.

Overall, the challenges of socially responsible investing are an integral part of the Fund's identity, as suggested in legislation and interpreted by the FRR Supervisory Board. Given its underlying aim, the FRR may request that its portfolio be managed according to SRI principles. But if it is to succeed, this effort must not remain isolated. It must be shared among all stakeholders – especially asset managers. Thanks to its status and size, the FRR is in a position to get the ball rolling. In building its own benchmark, the FRR will learn valuable lessons about the investment process and performance of a dedicated SRI fund compartment, whose defining characteristics will be known by the end of 2004.

The manager selection process

Request for proposals process

On July 31, 2003, the FRR launched the largest international RFP for the management of its reserves, totaling some 16 billion euros. The bid involves twelve asset classes and will result in the awarding of 27 asset management mandates as well as twelve stand-by mandates. The FRR reserves the right to multiply the number of mandates as needed, particularly in the interest of diversifying risk or in the event that one or more managers for the same lot are unavailable. The contract's twelve lots reflect the investment allocations set forth by the Supervisory Board in its statement on general investment policy orientations issued in April of 2003.

The Executive Board has set the term of the mandates at three years for Large cap eurozone equities, passive management (Lot 1) and Large cap US equities, passive management (Lot 4) and at five years for Small/mid-cap eurozone equities (Lot 2) and Mid-cap US equities (Lot 5). All other mandates have been set to run for a term of four years.

European directives and French legislation pertaining to government contracts govern this restricted, pan-European RFP. It entails a two-phase process: screening asset management firm applicants and selecting proposals from the short-listed applicants.

In compliance with the laws and regulations governing the FRR, the Manager Selection Committee assists the Executive Board in opening and analyzing applications throughout the RFP process. The Board also consults the Committee on specifications. During the various phases of the selection process, the Committee issues opinions intended to guide the Executive Board in its selection of applicants and proposals for the management mandates awarded by the Fund.

Selection of applications

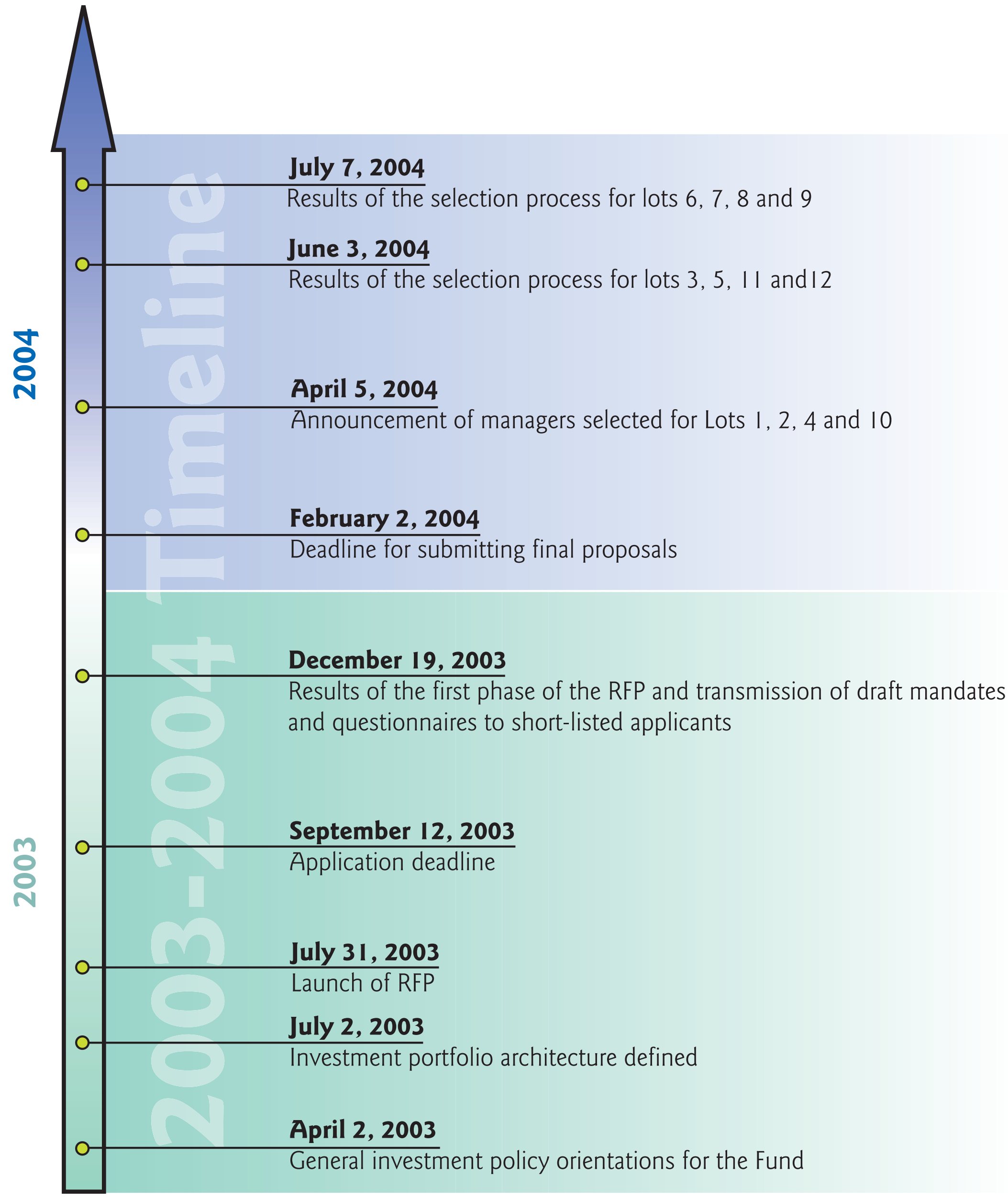
To be eligible for the RFP, firms must be investment companies whose primary activity is portfolio management on behalf of third parties. They may be based in France, in which case they must provide evidence of COB (now AMF) approval. Firms based in a member state of the European Union or a country that is party to the European Economic Area must show evidence of approval by the recognized authority in their country of domiciliation. To operate in France, they must have notified this authority, which liaises with the French regulatory authority, of their intent to operate in France by exercising their freedom to provide services on a cross-border basis or by establishing a branch office in France. Investment firms may apply for more than one lot.

The selection criteria for applicants, set forth in the bidding rules, were as follows:
- The company's experience in the financial management of similar mandates
- The company's financial strength and sustainability
- Compatibility of the investment company's organizational structure with the FRR's operational needs

The end of the first phase of the RFP was September 12, 2003, the deadline for submitting applications. On this date, the Manager Selection Committee met for the explicit purpose of (i) ensuring that the applications submitted were in conformity with the criteria set forth in the RFP guidelines, and (ii) analyzing each individual application for each of the twelve lots selected by the Executive Board.

In addition, the draft management mandates for each of the twelve asset classes and the phase 2 questionnaires, which together comprise the specifications, were finalized and approved by the Fund's supervising ministries.

The Executive Board announced the results of the Phase 1 selection to the investment firm applicants in mid-December of 2003. Of the 410 proposals submitted, 137 applications from roughly 60 different companies were selected. The selected applicants received an invitation to submit a formal proposal, accompanied by the information required to put together a bid – in particular, the management mandate contracts and related schedules, and a detailed questionnaire used to assess the capabilities and fitness of the competing firms. Throughout the process, the FRR received assistance from both Mercer Investment Consulting and the law firm of August & Debouzy.



Selection of proposals

The investment firms invited to submit a formal proposal in the second phase of the selection process were given until February 2, 2004, to put together and transmit their documents to the FRR. Proposals were assessed on the basis of the following criteria, as set forth in the RFP guidelines, listed in descending order of importance:

- Proposed management process
  - Dedicated human and technical resources
  - Consistency of this process with sources of performance
  - Compatibility with the FRR's financial objectives

- Quality of its operational organization
  - Risk management capability
  - Reporting
  - Range of solutions for technical collaboration with the FRR

- Total cost of management

Once the proposals were opened and analyzed, the highest-ranking applicants were contacted to schedule an interview with the Manager Selection Committee. The committee then submitted its report to the Executive Board. Following a particularly resource-heavy process, due to the number of proposals under consideration, the Executive Board announced the winners of the mandates.

Fund organization and management in 2003

In 2003, the FRR focused on building its organizational structure, a process that entailed managing a number of major projects simultaneously to set up infrastructures for operations, personnel, premises and information systems.

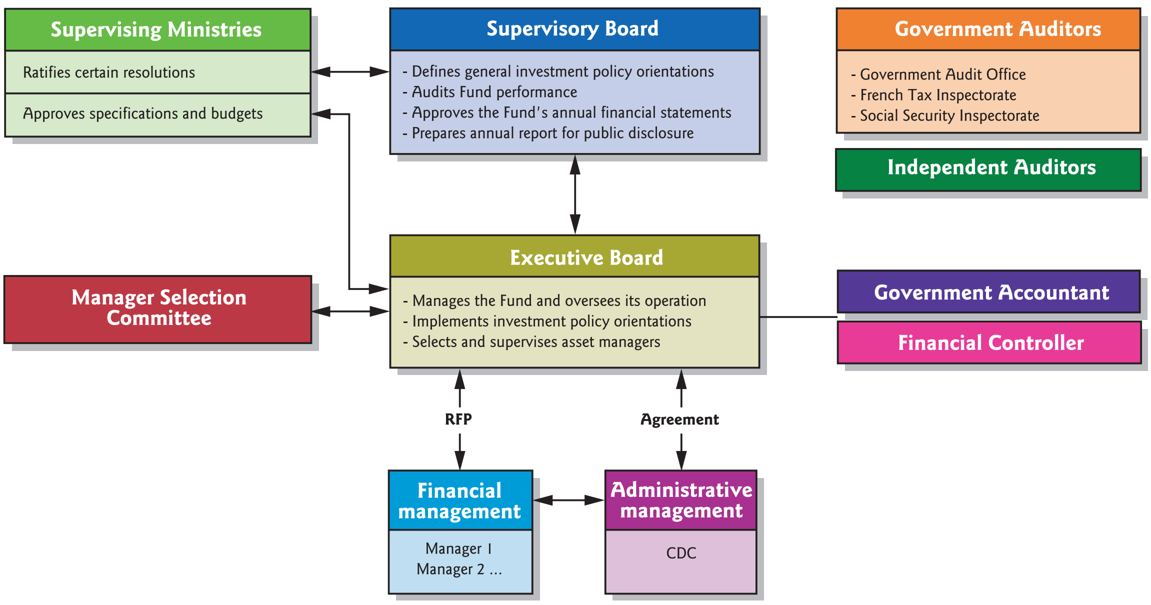
The Fund is divided into three departments, which counted a total of 26 employees at the 2003 year-end reporting date:

- **The Finance Department** prepares the strategic asset allocation orientations that the Executive Board presents to the Supervisory Board, analyzes proposals submitted by asset management firms, and produces the analytic tools that enable the Executive Board to make informed decisions on tactical asset allocation. The Finance Department will also be responsible for auditing the economic and financial performance of all running mandates.

- **The Operations and Risk Management Department** is responsible for setting up and monitoring shared or dedicated information systems, risk management, and the reporting tools. The department is also responsible for implementing and monitoring the Fund's securities accounting and data management systems.

- **The Administrative and Legal Department** is responsible for the legal aspects of the Fund's operation, including contract drafting and management (relations with investment firms throughout the term of their mandates and with the FRR's other service providers). It also manages the process of selecting service providers (bidding, relations with the FRR's legal advisors), monitors contractual relationships with the custody account-keeper for the Fund's assets (CDC), and is responsible for devising and implementing the Fund's proxy voting policy. Finally, the department handles relations with statutory auditors, manages the Fund's budget (definition and process, management control, authorization of revenue and expense appropriations), monitors the performance of the administrative management agreement with the CDC, and is responsible for the FRR's communications policy.

FRR Organization chart



The role of the Caisse des Dépôts et Consignations (CDC) and the relationship between the two publicly-owned agencies

Pursuant to the terms of the Decree of December 19, 2001, the CDC provides administrative management services for the FRR. In particular, these include the Fund's mission critical services, such as day-to-day cash-flow management, the custody services described in Paragraph 1 of Article L321-2 of the Monetary and Financial Code (*Code Monétaire et Financier*) and support for management systems implementation (see below).

The CDC carries out this mandate under the supervision of the FRR Executive Board, independently of its other activities. In return, the CDC receives management fees equal to the expenses incurred. The CDC's role falls within the scope of the legal provisions governing the FRR and the bylaws of the Fund's governance structures. A master agreement by and between the FRR and the CDC, defining the terms of this administrative management relationship, was approved by the Fund's supervising ministries and signed on June 26, 2003.

As part of this contractual arrangement, the FRR and the CDC sign an annual agreement on objectives, resources and performance (the *COMP – Convention d'Objectifs, de Moyens et de Performance*), in which they jointly describe the services and dedicated resources made available by the CDC in connection with its administrative management role. This agreement also sets forth the schedule of rates for services, defines relevant performance indicators for services rendered, and describes the budget process. It is updated each year to ensure consistency with the FRR's management objectives.

The FRR's budget for 2004 was drawn up on the basis of the first annual agreement on objectives, which was negotiated with the CDC in the fourth quarter of 2003. As part of this process, the FRR and the CDC wished to jointly identify indicators that would allow them to benchmark the CDC's services against prevailing market standards. Accordingly, the consulting firm McKinsey was commissioned by the Executive Board to determine relevant performance indicators and benchmarks, particularly for measuring custodial, depositary and valuation services.

The agreement, which will remain in force throughout 2004, contains a set of performance indicators that will enable the FRR to control the quality of the CDC's services. The number of indicators used will grow as the Fund's operations intensify.

Management systems

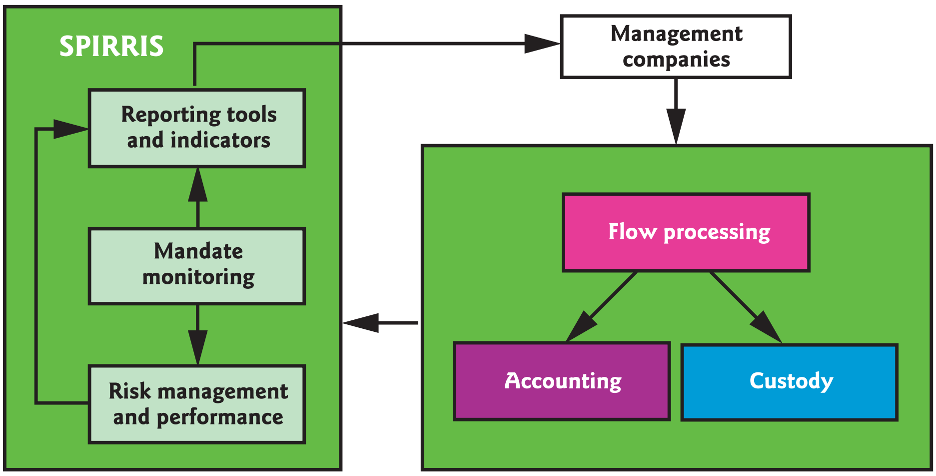
The CDC's experience in the field of custodial account keeping serves as the foundation for the FRR's securities operations. To minimize costs, the CDC uses the information systems of its securities subsidiary, which have been adapted to meet the particular needs of the FRR. At the same time, the Fund requires certain specialized tools to monitor risks and asset manager performance.

The FRR must be able to monitor and control a large number of asset management firms. Given the diversity of its investments in terms of countries, currencies and vehicles (marketable securities, futures, regulated market derivatives, private transactions), the Fund needs high-performance, state-of-the-art systems, adapted to each of the asset classes in its portfolio, to track the performance of management mandates.

The FRR is equipped with a management system that enables it to:

- Centralize orders placed by investment firms
- Track beneficial ownership ratios (i.e., statutory and legal thresholds for which notification is required, the prudential ratio limiting the stock and equity interest of a single issuer to 3%)
- Assess performance (control and analysis of the performance of each mandate against agreed-upon management and risk objectives)
- Exchange secured data with each investment firm
- Archive internal data as well as data provided by investment firms

Functional architecture



The FRR monitors the financial transactions carried out by managers using an in-house tool called SPIRRIS (Système de Pilotage, Reporting, Risques). This dedicated tool provides data management, flow integration, restoration, control, and calculation functionality. It can also be used to produce management reports and scorecards that allow the FRR's governance structures to verify that the investments carried out by the management firms comply with their mandates and assess the quality of services rendered.

For the purposes of risk management, which encompasses both the individual financial risks associated with each mandate and risks to which the Fund is exposed globally, the FRR uses both an in-house tool and the services of financial information suppliers with expertise in compiling indices and economic and financial series.

The FRR is a stand-alone unit with a proprietary accounting system, whose various components (general and cost accounting, inventory and annual report) fall under the scope of responsibility of the Fund's accounting officer.

Budget items

The FRR's budget was adopted by the Executive Board in March of 2003 and subsequently approved by its supervising ministries. It should be noted that the Fund's 2003 budget does not yet include operating expenses. These expenses, which reflect active financial management, will come into play once mandates have been awarded and operations are in full swing.

FRR's operating expenditure for 2003 is broken down in more detail below, and its budget is presented in conformity with the chart of accounts for social security organizations.

FRR BUDGET - 2003	M€
Payroll expense (1)	3,739
Overhead costs/support, logistics (2)	1,511
IT (dedicated system) (3)	0,332
Custody and fund administration (4)	1,345
Start-up costs*	5,156
Consulting and other outsourced services (5)	1,620
Financial management fees (6)	0,000
TOTAL	13,703

** These start-up costs reflect the cost of services carried out by the CDC on behalf of the FRR (expenses committed in 2001 and 2002 to cover administrative start-up coasts)*

1. Payroll Expense

Payroll expense reflects

- *Compensation and benefits paid to the two members of the Executive Board and the Accounting Officer*
- *Indemnities granted to the members of the Manager Selection Committee*
- *Compensation and benefits paid to other employees of the Fund: payroll expense relative to employees placed under the authority of the FRR Executive Board (26 employees at year-end 2003), expenses related to temporary staffing and training costs.*

2. Overhead/Support, Logistics

Office rental and telephone expenses totaling 803,000 euros; supplies, office equipment and business travel costs; CDC support functions (such as personnel management, invoice processing, communications support and website construction) totaling 593,000 euros.

3. Information Technology (dedicated system)

Leasing and rollout of a software package, loan of office equipment.

4. Custody and Fund Administration

Setup costs. Work to adapt CDC systems to FRR needs (portfolio/securities accounting, general accounting).

5. Consulting and Other Outsourced Services

Consulting fees: technical and financial assistance for the asset manager selection process; legal counsel and IT project management support. Miscellaneous services (translation, communications, etc.), postage and mailing costs, business travel costs.

6. Financial management fees

Non-material in 2003, financial management fees will be incurred as of 2004, as portfolio management mandates begin to run.

Cash management

Since the Fund was established, and pending the rollout of its financial management mandates, the FRR has conducted a cash management strategy that seeks to ensure both the security and availability of funds.

In 2003, the FRR gradually transferred the balance of its interest-earning current account with the Treasury Central Accounting Office (*Agence Comptable Centrale du Trésor*, or *ACCT*) to a time-deposit account, held initially with the ACCT and then with the CDC.

To protect the FRR's cash assets from any interest rate fluctuation whatsoever, they are systematically split between fixed-rate and floating-rate accounts. This conservative cash investment policy enabled the FRR to earn investment income of 425.78 million euros between July 1, 2002, and December 31, 2003. Based on an average daily cash balance of 11.68 billion euros, this sum represents a return of 2.43%.

The FRR's cash position, a balance of 14.66 billion euros at December 31, 2003, will be managed in accordance with these same conservative principles until management mandates begin running.

Current and future projects

1 - Other requests for proposal

Concurrent with the asset manager selection process, the FRR began the formal process of searching for and selecting a Transition Broker and an Overlay Manager for its tactical asset allocation and foreign exchange risk. Launched in January of 2004, these selection processes are being carried out in conformity with the so-called competitive dialogue procedure described in the new French government procurement code (*Code des Marchés Publics*). Under the new procedure, the FRR is able to define technical specifications in conjunction and dialogue with those participating in the RFP process.

- The **Transition Broker's** role is to execute orders to buy or sell financial instruments on behalf of the FRR, or to receive and transmit these orders for execution, during periods of portfolio activation. The broker acts via asset managers. In terms of security and cost, this mandate will help to optimize the construction of the FRR's portfolios. Since a massive inflow of cash may cause market imbalances, it is necessary to obtain the services of a skilled professional whose role is to limit price impacts during the transition period.

- The **Overlay Manager** will develop an advisory role with respect to the FRR Executive Board as tactical asset allocation strategies are implemented, and will manage the portfolio's foreign exchange exposure.

In connection with these two mandates, the FRR is assisted by a financial consultant (Mercer Investment Consulting) and legal counsel (Allen & Overy).

2 - Pending the completion of the manager selection process planned for the end of the first half of 2004, the FRR has embarked on the preparatory work for **portfolio activation** with the asset management firms that have already been selected. It will then be up to the FRR Executive Board to make investment decisions based on prevailing financial market conditions.

3 - By the end of 2004, the FRR Executive Board intends to meet the following two objectives: to submit to the Supervisory Board a **set of guidelines** detailing foundations of the Fund's policy with respect to proxy voting rights, and to fully explore technical issues prior to launching RFPs for **dedicated socially responsible investment** and **private equity** components.

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FRR

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