

## **Key Points and Issues For April 2008**

### **Director's Note**

While credit concerns still overhang the global financial markets, there was a significant rebound in April in response to actions taken by the Federal Reserve. In particular, the Fed's actions to backstop Bear Stearns and to provide additional liquidity through existing and new credit facilities caused investors to believe that authorities would take additional action to support asset prices in the United States.

While no one could anticipate these events, we did come to believe early this year that risk premia in U.S. equities and corporate bonds were attractive by historical standards. As a result, we deferred additional sales of U.S. equities (as called for by our FY 2008 Investment Plan) and were net buyers of more than \$1.8 billion in corporate bonds during the first four months of 2008. These investments, along with our investments in several credit-oriented funds that were made last year, all had strong returns in April.

As in past months, our underexposure to commodities continues to be the major driver of negative performance relative to our benchmark. While we continue to gradually increase our exposure to this asset class (we invested an additional \$100 million in April), we have been waiting for a much-anticipated correction to provide a more attractive entry point.

### **Total Pension Funds**

- Estimated performance for the pension funds for the fiscal year-to-date period is 0.88% versus 1.95% for the Council benchmark. For the month of April, the fund was up 2.91% versus 3.11% for the benchmark. The underperformance relative to the benchmark for the month and fiscal year to date periods is primarily attributable to our underweight position in commodities, which are up by nearly 48% for the fiscal year to date period. Total pension fund assets as of April 30, 2008 were \$81.5 billion.
- We were net sellers of \$120.4 million of U.S. equities in April. In addition, we increased our put hedges to protect an additional \$300 million in underlying equities. Within the international portfolio, we were net sellers of \$146.2 million of developed markets equities, but purchased \$160 million of emerging markets equities. Within domestic fixed income, we were net buyers of \$305.1 million, consisting of purchases of long-term corporate bonds, municipal auction rate securities and TIPs, offset by sales of nominal U.S. Treasuries and mortgage backed securities.
- During April, we transferred \$300 million out of domestic equities (Common Fund A) and into alternatives (Common Fund E).

## **Domestic Equity**

- Performance for Common Pension Fund A for April was 5.14% versus 5.06% for the S&P 1500 Index, the benchmark for the domestic equity portfolio. For the fiscal year-to-date period, Common Pension Fund A returned -4.62% versus -6.48% for the benchmark. Our outperformance in April was primarily attributable to our underweight exposure to GE and our large exposure to several wireless tower operators (e.g., Crown Castle, American Tower). For the fiscal year-to-date period, our underexposure to financial stocks is the major contributor to our outperformance.
- As stated above, net sales of equities within Common Pension Fund A during April were \$120.4 million. While sales were spread throughout the portfolio, the major activity was in the industrial and technology sectors. Within industrials, the major sales were in GE, Norfolk Southern and JB Hunt. Within technology, we were sellers of Cisco, Texas Instruments and IBM. Partially offsetting these sales were purchases in the telecom sector, where we were buyers of AT&T, SBA Communications and MetroPCS Communications.
- As discussed above, we increased our put hedges in order to protect an additional \$300 million of underlying equity securities. In total, we have hedges on \$925 million of the overall portfolio, and a collar (i.e., we purchased puts and sold calls) on roughly \$420 million of stocks in the financial sector.
- According to Barra's models, Common Pension Fund A (excluding the cash and put option hedges in the portfolio) has an estimated tracking error of 116bp versus the index. This risk level has remained fairly constant in recent months.

## **Domestic Fixed Income**

- Performance for Common Pension Fund B for April was 0.21% versus -0.02% for the Lehman Long Government/Credit Index, the new benchmark for the domestic fixed income portfolio. For the fiscal year-to-date period, Common Pension Fund B was up 10.61% versus 8.37% for the benchmark. Please note that the Common Fund B performance numbers include our TIPs portfolio, which does improve our comparison with the index somewhat for the fiscal year-to-date period. The duration of Common Pension Fund B (excluding TIPs) was 9.54 years as of April 30, 2008, versus 11.24 years for the Lehman Long U.S. Government/Credit Index.
- We had net sales of approximately \$305.1 million in domestic fixed income securities in April. The net number somewhat masks a great deal of activity in the portfolio for the month. We had \$595.9 million in net purchases of long-term corporate bonds, mostly in the new issue market. Major issuers that were purchased include Bristol Myers, Lehman Brothers, Oracle and Verizon. For the calendar year-to-date period, we made \$1.8 billion in net purchases of U.S

corporate bonds. In addition, we had net purchases of roughly \$200 million in auction rate municipal securities. The current yield on this portfolio is near 5%, and some of our purchases in the beginning of the month were at yields approaching 10%. As the market dislocation in the auction rate municipal market subsides, we expect that this portfolio will shrink or run off entirely. In addition, we had net purchases of \$140 million of TIPs, believing that the breakeven inflation spread priced into long-term TIPs was attractive given the continuing run-up in commodity prices. Offsetting these purchases were sales of \$374 million in nominal U.S. Treasuries and \$176.7 million in 30-year mortgage-backed securities.

### **International Equity/Fixed Income**

- The equity portion of Common Pension Fund D returned 4.33% in April versus a 5.02% return for the MSCI EAFE Index ex-Sudan, the new benchmark for the international portfolio, which is calculated by the Division and excludes those names deemed ineligible for investment under the State's Sudan Divestment Law. For the fiscal year-to-date period, the portfolio was down -3.84% versus -3.96% for the benchmark.
- We were net sellers of \$146.2 million in international developed markets equities in April. The major activity was in the consumer discretionary and consumer staples sectors. Major sales in the portfolio include Pernod-Ricard (\$87.8 million), Reuters (\$87.7 million), Groupe Danone (\$67.2 million) and Diageo (\$44.8million).
- Within emerging markets we continue to transition the portfolio to our four external managers. During April, we transferred an additional \$160 million to our externally managed portfolio. The total market value of the emerging markets equity portfolio is \$949.2 million.
- We added \$139 million to our international fixed income portfolio in April, primarily in long-term Australian bonds. In addition, we transferred roughly \$150 million out of short-term JGBs into short-term Euro-denominated paper. Finally, we hedged the currency risk on virtually the entire \$500 million long-term European sovereign portfolio.
- The following companies, while incorporated in a developed market country, will be classified as emerging market companies based upon our review of the various factors as set forth in the State Investment Council Regulations: China Netcom Group, China Resources, China Resources Land Limited, Focus Media, New World Resource, X5 and Zentiva NV.

### **Alternatives**

- During April, we funded \$280 million of commitments to alternative investments, including an additional \$100 million to the commodity fund managed by Schroders, \$25 million to Carlyle Mezzanine Fund II and \$22.6 million to the PIMCO Distressed Mortgage Fund. Offsetting these investments was a redemption of \$100 million from a multi-strategy hedge fund managed by Barclays Global Investors (BGI).
- We estimate that our hedge fund portfolio was up 2.20% for April. The strongest returns were in several of our credit-oriented funds, which rebounded nicely given the improvement in credit markets.

### **Cash Management Fund**

- Total assets in the Cash Management Fund were \$21.0 billion as of April 30, 2008. This amount is significantly higher than in prior months, which is mostly attributable to the inflow from State income tax receipts. The current yield is 2.62% for state participants, and 2.52% for “non-State” participants. The yield continues to decline in response to recent Federal Reserve actions to reduce the target federal funds rate.