

Key Points and Issues For October 2008

Director's Note

While the fallout from global credit crisis has been dragging on financial markets for over the past year, October 2008 was by far the worst month in terms of investment performance across all asset classes. While unprecedented bold action by world governments and central banks has finally started to ease some of the stresses in the global credit markets, markets now seem to be pricing in a serious global recession that will likely result from these events.

The performance of New Jersey's pension fund in October 2008 was sobering, but should not be unexpected. The fund was -12.72%, which was actually ahead of our overall benchmark return of -13.71%. The performance of each of our major portfolios was roughly in line with the overall market, but we were helped somewhat by being overweight U.S. equities and fixed income relative to international equities (which had the worst performance of any portfolio due to the rapid appreciation of the U.S. dollar).

While various news outlets have been reporting that many pension funds and endowments have been "forced sellers" of public equities and bonds as a means to raise needed cash for other purposes, New Jersey was an aggressive buyer of both investment grade corporate bonds and domestic and international equities during October. In particular, we have been finding exceptional value in U.S. corporate bonds and "long duration" international equities in the telecom and utility sectors, which both offer current yields that are comparable to our long-term equity return assumptions. Details on our activities in these areas are found below.

Total Pension Funds

- Estimated performance for the pension funds for the fiscal year to date period through October 31, 2008 is -20.66% versus -22.35% for the Council benchmark. For the month of October, the fund was -12.72% versus -13.71% for the benchmark. Our outperformance for the fiscal year was attributable to (1) our underweight position in commodities relative to the benchmark, and (2) our overweight position in domestic equities and domestic fixed income relative to developed markets international equities. Total pension fund assets as of October 31, 2008 were \$61.9 billion.
- We were net buyers of \$418.0 million in our U.S. equity portfolio in October, which included roughly \$220 million of long-term corporate bonds at yields ranging from 8%-10.5%. For the fiscal year to date period, we were net sellers of \$101.1 million. Within the international portfolio, we were net buyers of \$1.275 billion, consisting primarily of "defensive" utility, telecom and pharmaceutical stocks. For the fiscal year, we were buyers of \$1.1 billion. Offsetting these

purchases were sales of \$1.8 billion of international sovereign bonds during September-October. Within domestic fixed income, we were net buyers of \$364.4 million, consisting of \$1.1 billion in purchases of long-term corporate bonds partially offset by sales of U.S. Treasuries and TIPs. Finally, we funded an additional \$584.2 million in commitments to various alternative investments in October.

Domestic Equity

- Performance for Common Pension Fund A for October was -17.02% versus -17.32% 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 -23.71% versus -24.19% for the benchmark. Our performance for both periods was helped by our put hedge positions and high cash position in the portfolio during September and early October.
- As stated above, net purchases within the portfolio in October were \$418.0 million, including approximately \$220 million of long-term corporate bonds. In several cases, we sold underlying equity positions where we could purchase bonds with superior yields and expected long-term return potential. Within the equity portfolio, the major thrust was to increase exposure in “defensive” areas and to decrease our exposure to cyclical sectors. We were net buyers within health care, consumer staples, and telecom, while selling technology stocks. The major issues that were purchased during the month were Union Pacific (swapping out of Fedex, Norfolk Southern and Burlington Northern), AT&T, Verizon, Merck and Schering Plough.
- We eliminated our \$1.7 billion of put option hedges on the S&P 500 index in late September and early October around the market lows.

Domestic Fixed Income

- Performance for Common Pension Fund B for August was -6.79% versus -7.17% for the Lehman Long Government/Credit Index, the benchmark for the domestic fixed income portfolio. For the fiscal year to date period, Common Pension Fund B returned -10.83% versus -10.32% for the benchmark. The duration of Common Pension Fund B (excluding TIPs) was 9.12 years as of October 31, 2008, versus 10.45 years for the Barclays Long U.S. Government/Credit Index.
- We had net purchases of approximately \$364.4 million in domestic fixed income securities in October. This number consists of \$1.1 billion in purchases of long-term corporate bonds, partially offset by sales of U.S. Treasuries and TIPs. Most of these corporate bond purchases were in early October around the market lows. As noted above, we see strong relative value in long-term investment grade corporates at current yield levels. Major names that were added to the corporate

bond portfolio were AT&T, Bristol Myers, Cameron, Coke, Glaxo Smith Kline, IBM, Kellogg, Eli Lilly, Pepsico, Procter & Gamble, and United Technologies.

- As noted in prior months' reports, we began to purchase various issues of municipal "auction-rate" securities after their interest rates increased dramatically in response to the problems encountered by the monoline insurers. At several points over the past six months, the rates offered on such securities exceeded 10% on an annualized basis. This portfolio at one point was as high as \$300 million; as of October 31, the portfolio has been reduced to \$83.6 million as the opportunities for investment in this market become less attractive.

International Equity/Fixed Income

- The equity portion of Common Pension Fund D returned -21.57% in October versus a return of -20.72% for the MSCI EAFE Index ex-Prohibited, 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 and Iran Divestment Laws. For the fiscal year, the portfolio was down -36.63% versus -36.52% for the benchmark. Our portfolio of international sovereign bonds which at one point exceeded \$2 billion (all of which were hedged into U.S. dollars) returned +5.08% for the month and +5.61 for the fiscal year to date period.
- We were net buyers of \$1.275 billion in international developed markets equities in October, consisting primarily of issues in defensive sectors such as health care, telecom and utilities. Most of these purchases took place in the first two weeks of October near the market lows. Major names that were purchased in health care include Glaxo Smith Kline, Merck AG and Roche. Within telecom, the major names that were purchased include Swisscom and KPN. Finally, within the utility sector, E.on, Fortum, Scottish Power, GDF-Suez, RWE and National Grid.
- We significantly reduced our portfolio of long-term European sovereign debt and short-term JGBs in September-October. Our total portfolio of such securities is now \$980 million, down from over \$2 billion as of August 31, 2008.

Alternatives

- During October we funded \$584.2 million of commitments to alternative investments. Major investments include \$144.0 million to Blackrock Credit Investors, \$49.5 million each to Canyon Special Opportunities and Golden Tree Credit Opportunities, and \$40.0 million to Avenue Special Situations Fund.
- Our preliminary performance for the hedge fund portfolio in October is -10.0%. The major factor contributing to this number was the negative returns on our various credit-oriented funds, which were impacted by the unprecedented

falloff in corporate bonds and bank loan markets. These markets have started to recover in November.

Cash Management Fund

- Total assets in the Cash Management Fund were \$13.3 billion as of October 31, 2008. The current yield is 2.00% for state participants, and 1.86% for “non-State” participants.
- The percentage of the portfolio invested in US T-bills/Notes, U.S. Agencies and Canadian government securities is now 76.8%, which is the highest percentage in many years. This increase is driven by our credit concerns of various issuers in this market; we have both eliminated names eligible for purchase and reduced our credit limits on other issuers.