

Key Points and Issues For January 2008

Director's Note

As we have discussed, the portfolio going into 2008 had an extremely risk-averse posture. Given our concerns pertaining to the global credit markets, we took several major steps throughout calendar year 2007 to reduce the risk profile of the portfolio: underweighting financial stocks in both our domestic and international equity portfolios, hedging downside risk on the domestic equity portfolio via index put options, significantly improving the credit quality of our bond portfolio relative to our benchmark (including the virtual elimination of any credit exposure to the banks and brokers), maintaining a large cash position in Japanese yen, and deferring additional investments in emerging markets equities and commodities.

During January, we started to reverse some of these positions. While we are still cautious about the markets, we feel that the markets are well on their way to "pricing in" concerns about global credit conditions (and the resulting weakness in the global economy). In addition, the Federal Reserve has now started to aggressively cut interest rates in order to offset weakness in the U.S. economy that will certainly result from the problems in the housing and credit markets.

While it is impossible to predict what impact aggressive monetary stimulus will have on the markets, we think looking back to the 1989-1991 period is appropriate. Then, the U.S. financial system also was under stress, primarily from non-performing commercial real estate loans that caused the S&L crisis. In response to these issues, the Federal Reserve started to aggressively cut interest rates in late-October 1990, bring rates down from 8% to 3% over a two-year period. In the twelve months prior to October 1990, the S&P 500 declined more than 9%, and financial stocks were down nearly 39%. Over the 12-month period after the first rate cut, the S&P 500 rose by 28%, and financial stocks were up more than 60%. By way of comparison, in the twelve months prior to the Fed's 75bp cut in mid-January 2008, the S&P 500 was down 7%, and financial stocks were down more than 31%.

As discussed in more detail below, the Division started to reduce its underweight exposure by purchasing \$700 million in convertible preferred stock issued by Citigroup and Merrill Lynch. In addition, we reduced our index put hedges, were net purchasers of corporate bonds, eliminated our Japanese yen cash position, and made a modest addition in our emerging markets equity portfolio.

Total Pension Funds

- Estimated performance for the pension funds for the fiscal year-to-date period is -1.26% versus -0.16% for the Council benchmark. For the month of January, the fund was down -3.78% versus -3.42% for the benchmark. The underperformance

relative to the benchmark for the fiscal year-to-date period is attributable to our underweight position in commodities and emerging markets equities. Total pension fund assets as of January 31, 2008 were \$78.1 billion.

- We were net sellers of \$453.0 million of U.S. equities in December (this number is net of our \$700 million in convertible preferred stock mentioned above). In addition, we reduced the hedge from our S&P 500 index put exposure from \$2.2 billion to slightly more than \$900 million. Within the international portfolio, we were net buyers of \$539.0 million, mostly in the European telecom and utility sectors. Within the international bond portfolio, we eliminated our \$600 million in holdings of short-term Japanese Government Bonds (JGBs), but purchased roughly \$500 million in 30-year European sovereign debt. Within domestic fixed income, we were net buyers of \$165.7 million in U.S. Treasury Inflation Protected securities (TIPs), and also swapped more than \$500 million from the front end to the back end of the TIPs curve. In addition, we were net buyers of \$249.2 million in long-term corporate bonds, and sellers of \$794 million in 5- and 10-year U.S. Treasury notes.
- During January, we transferred \$1 billion out of Common Pension Fund A (domestic equities). Of this amount, \$500 million was transferred into Common Pension Fund D (international) to fund our purchases of long-term European sovereign debt, and \$500 million was transferred into the Common Pension Fund E (alternatives).

Domestic Equity

- Performance for Common Pension Fund A for January was -6.24% versus -5.98% 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 -6.45% versus -7.68% for the benchmark. Our underperformance in January was primarily attributable to our overweight exposure in technology and media stocks. The main factors contributing to our outperformance for the fiscal year-to-date period were (1) our underweight position in financial sector equities, (2) stock selection within the industrial and technology sectors and (3) recoveries on securities litigations settlements (which were discussed last month).
- As stated above, net sales of equities within Common Pension Fund A during January were \$453.0 million. While sales were spread throughout the portfolio, the major activity was in the industrial and technology sectors. Within industrials, we were sellers of Burlington Northern (\$57.4m), Norfolk Southern (\$55.9m), Boeing (\$39.8m) and Deere (\$25.5m). Offsetting these sales was the purchase of \$87.3 million in Fedex. Within technology, the major activity was the sale of IBM (\$41.6m), Qualcomm (\$38.0m) and Microsoft (\$36.4m).
- As discussed at last month's Council meeting, the Division invested in two convertible preferred stock offerings in January: \$400 million with Citigroup and \$300 million with Merrill Lynch. The Citigroup security is a perpetual preferred with a 7% yield, while the Merrill Lynch security is a mandatory convertible

preferred with a 9% yield. Offsetting these purchases were net sales of \$156 million in other non-REIT financial sector stocks (Morgan Stanley, Goldman Sachs, Bank of America). Finally, we were net buyers of \$131 million in REIT stocks in response to recent weakness in the sector.

- As discussed above, we again reduced our put option hedges in reaction to the drop in the U.S. equity markets and the rise in equity-implied volatility in January. We currently have puts that provide protection on roughly \$900 million in equities, down from \$2.2 billion as of December 31, 2007.
- According to Barra's models, Common Pension Fund A (excluding the cash and put option hedges in the portfolio) has an estimated total risk level (i.e., projected standard deviation of returns) of 13.5%, versus 13.2% for the S&P 1500. The portfolio has a tracking error of 109bp versus the index, up slightly from last month.

Domestic Fixed Income

- Performance for Common Pension Fund B for January was 1.87% versus 1.05% 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 9.86% versus 8.68% 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. While our relative performance was again hurt given that portfolio duration is below that of the benchmark, this was offset by our underweight position in credit risk relative to the overall market. The duration of Common Pension Fund B was 8.81 years as of January 31, 2008 (excluding the TIPs), versus 11.27 years for the Lehman Long U.S. Government/Credit Index.
- We had net sales of approximately \$426.7 million in domestic fixed income securities in January. The major sales were in 5- and 10-year U.S. Treasury notes, where we sold \$794 million. The proceeds of these sales were used to fund purchases of corporate bonds and TIPs (discussed below), with the remainder transferred back to the seven pension systems in order to fund future benefit payments.
- Within the corporate bond portfolio, we had gross purchases of \$602.9 million in long-term corporate bonds. Major names that were added in the month include General Electric, TVA, Walmart and Wachovia. Offsetting these purchase were sales of roughly \$401.5 million in short-term corporates and asset-backed securities. Finally, we were net buyers of \$165.7 million in TIPs, and also sold \$500 million in short-term TIPs (within 5 years of maturity) in order to purchase 20-year and 30-year TIPs.

International Equity/Fixed Income

- The equity portion of Common Pension Fund D returned -9.98% in January versus a -9.06% 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 -9.02% versus -8.94% for the benchmark.
- We were net buyers of \$539.0 million in international equities in January. The major activity was in the European telecom and utility sectors, where we were buyers of \$694.7 million. The major names that were bought include Red Electrica de Espana (\$159.0m), Vodafone (\$104.0m), Bouygues (\$82.4m), Scottish and Southern Energy (\$73.9m) and France Telecom (\$51.7m).
- Within emerging markets we continue to transition the portfolio to our four external managers. During January, we transferred nearly \$350 million to our externally managed portfolio. Offsetting these transfers were net sales of \$213 million in internally managed equities in Brazil, Mexico and South Korea.
- Within international fixed income, the major activity was the elimination of our \$600 million in short-term yen-denominated JGBs, and the purchase of \$500 million in 30-year European sovereign debt. Of the \$500 million in purchases, \$172 million is hedged back into U.S.dollars.
- 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: BYD Electronics, CNOOC Ltd., China Overseas Land & Inv., First Pacific, Golden Meditech, Shenzhen, Sino-Ocean and Yangzijiang Shipbuilding.

Alternatives

- During December, we funded \$307 million of commitments to alternative investments: \$206 million in private equity, \$84 million in real estate and \$17 million in absolute-return funds. In addition, we received \$400 million in late-January from the maturities of commodity-linked notes with Merrill Lynch and Lehman; of this amount, \$300 million was invested with our two commodities managers (Schroders and Gresham).
- We estimate that our absolute return portfolio was down -2.66% for January. As discussed at last month's Council meeting, the main objective of the absolute return portfolio is to reduce the overall volatility of the fund. Given that U.S. and international stocks were down -5.98% and -9.24% respectively in January, we believe that the absolute return portfolio met that objective.

Cash Management Fund

- Total assets in the Cash Management Fund were \$17.5 billion as of January 31, 2008. The current yield is 3.88% for state participants, and 3.78% for “non-State” participants. The yield continues to decline (both yields are down by 74 bp for the month) in response to recent Federal Reserve actions to reduce the target federal funds rate.
- A major objective in January was to reduce the portfolio’s exposure to bank CDs. As of December 31, 2007, the Fund had 54.1% invested in CDs. We are pleased to report that the CD exposure as of January 31, 2008 was reduced to 37.4%.