

OPERATIONS SECTION

Investment and Corporate Governance

Investment Policy and Strategy

The Investment Plan adopted by the Council for fiscal year 2007 resulted in several significant changes in the allocation and management of plan assets.

The Council, assisted by Division staff throughout 2006, undertook an extensive analysis that attempted to quantify the risk/return profile of potential asset allocations. The result was a new set of asset allocation targets starting in fiscal year 2007 designed to reduce overall risk to the Pension Fund, including inflationary risks, and to better match Fund performance to actuarial obligations. To further ensure these goals, the number of asset classes was broadened to incorporate alternative investments and a greater number of traditional asset classes.

Asset class targets for fiscal year 2007 are as follows. (It should be noted that “targets” as approved by the Council refers to central tendencies within a range, rather than hard target amounts):

Total Equities Target: 55.7 percent. Includes domestic equities, 30.7 percent; international equities in developed markets, 22.5 percent, and in emerging markets, 2.5 percent.

Total Fixed Income Target: 31 percent. Includes U.S. fixed income, 25 percent; U.S. high yield, 3 percent; and Treasury Inflation-Protected Securities (TIPS), 3 percent.

Alternative Investment Target: 10.3 percent. Includes private equity, real estate and hedge funds, as well as commodities and other real assets.

Cash Target: 3 percent.

Benchmarks for asset performance in fiscal year include the Standard & Poor’s Composite 1500 Index for domestic equities; the Morgan Stanley Capital International-Europe, Australia and Far East Index (MSCI EAFE ex-Prohibited securities) for international equities; a blend of the Lehman U.S. Government/Credit and Lehman Long Government/Credit indices for domestic fixed-income; and the 90-day Treasury bill performance for cash.

Additionally, the fiscal year 2007 Investment Plan proposed for the first time that several new and traditional asset classes be managed entirely or in part by external managers, including international equities, high-yield debt and emerging market investments, so that the Fund could avail itself of those most skilled in such investments to complement Division personnel. Although approved by the Council in 2006, implementation of this external management policy did not begin until the fiscal year ending June 2008.

Council Regulations and Business

In addition to the investment guidelines established by law, the State Investment Council sets specific investment policies by regulation to keep Council policies current with economic and fiscal trends, in accordance with its fiduciary responsibility and the authority provided under P.L. 1950, c.270.

All proposed regulations and amendments are filed with the Office of Administrative Law for publication in *The New Jersey Register*. Following a 60-day public comment period,

proposals and all comments are brought to the Council for action or adoption. All regulations of the State Investment Council are published in the New Jersey Administrative Code (N.J.A.C. 17:16).

In fiscal year 2007, the Council:

- **Re-adopted with amendments all SIC regulations** (N.J.A.C. 17:16) after extensive review, as mandated by law every five years. Amendments included in the re-adoption: adding the flexibility to opportunistically purchase high-yield securities; flexibility to invest in interest-rate swaps; flexibility to increase the maximum futures exposure from 10 percent of the portfolio up to 50 percent after formal consultation with the Council's Executive Committee; and granting the ability to use index options and to remove the 10 percent limitation on option securities. Changes adopted to the Alternative Investments Program included: increasing the maximum commitment to any one fund to 10 percent of the asset class allocation, reverting to 5 percent when the commitments reach \$5 billion; increasing the limit on investment in private equity, real estate, real assets and hedge fund strategies to 7 percent of the Pension Fund assets.
- **Approved the engagement of external managers** (N.J.A.C. 17:16-2) for management of several new and traditional asset classes either entirely or in part, including small- and mid-cap equities, high-yield debt and emerging market investments. Implementation of this external management policy began in 2008.
- **Amended the Division's broker firm eligibility policy** to allow the Division greater flexibility in accessing smaller brokerage firms able to provide valuable research.
- **Modified the caps on international developed and emerging markets, and the limitation on total plan assets that can be invested in high-yield debt**, to give the Division increased flexibility to exceed Investment Plan targets when it believes the market offers attractive or potential returns. Additional minor amendments were also approved by the Council to bring regulations in line with the current year Investment Plan. Note: All approved amendments took effect in August 2007. (N.J.A.C. 17:16-12, 14, 15, 16, 19, 20, 31, 33, 44, 46, 47, 58, 62, 67, 69, 71, 90 and 100)

The Council also reviewed outside professional analysis on the following investment policy issues:

- **Market value of pension plan assets against anticipated liabilities.** A study by Ryan Labs, Inc. presented in March 2007 addressed Council concerns about pension liabilities from an investment, rather than the customary accounting or actuarial, perspective. The study estimated the Pension Fund has a market value shortfall of more than the state-estimated actuarial shortfall when comparing the present value of benefits payments against the market value of pension assets as of September 30, 2006. The study illustrated why the Division has begun to extend the duration of fixed-income assets in the portfolio, and why it is examining other long-term, cash flow-producing assets, such as infrastructure.

- **The value of infrastructure as a potential pension plan asset class.** An analysis presented to the Council in May 2007 by Strategic Investment Solutions noted that the need for longer-duration cash flows is being considered by pension funds worldwide, with infrastructure investing (primarily energy, transportation and water investments) pursued by the governments of Australia and Canada among others. The 2007 Investment Plan considered infrastructure investment part of the inflation-sensitive asset class allocated a total 7 percent in the fiscal year portfolio. According to Strategic Investment Solutions, the role of infrastructure investments for the New Jersey fund would be primarily to hedge inflation risk, increase the fund's diversification, enhance returns and provide for stable, long-term cash flows.

The Council underwent the following organizational changes in fiscal year 2007: (Note: additional structural changes to the Council were made in July 2007, and will be reported in the upcoming annual report for fiscal year 2008.)

- The re-election of five members to Council seats by their respective pension boards, for one-year terms: Suzanna M.F. Buriani-DeSantis, Public Employees Retirement System; George A. Castro, Consolidated Police & Firemen's Pension Fund; James Clemente, Teachers' Pension and Annuity Fund; Vincent Foti, Police and Firemen's Retirement System; and John K. Sayers, State Police Retirement System.
- The re-election of Orin Kramer as Council Chair, and the election of Vincent Foti as vice chair.
- The resignations of public members Cheryl A. Mills, James. M. Farrell, Esq., and Anthony Terracciano.

Corporate Governance

The Council and the Division worked proactively during fiscal year 2007 to protect and advance the Pension Fund's shareholder interests in the corporations in which it is invested. Specifically, the Division:

- **Voted its domestic proxies in support of greater corporate board accountability.** The Division voted 1,266 proxies of U.S. companies in fiscal year 2007; this compares with 1,315 proxies and 1,255 proxies voted in fiscal years 2006 and 2005, respectively. The Division voted with management on all issues in 765 proxies. It voted against management on 639 individual proposals in the remaining 501 proxies. In general, the Division voted against the recommendation of management on issues that reduced board accountability, including proposals for exorbitant stock options and incentive or restricted plans for directors. In general, the Division supported proposals that would increase board accountability, including majority voting in the election of directors, advisory voting on executive compensation, the annual election of directors, the end of supermajority voting and pay tied to performance.
- **Voted its international proxies in support of greater corporate disclosure and improved board accountability.** The Division voted 579 proxies with internationally based companies in fiscal year 2007; this compares with 575 proxies and 505 proxies in fiscal years 2006 and 2005, respectively. The

Division voted with management on all issues in 428 proxies. It voted against management on 219 individual proposals in the remaining 151 proxies. The Division supported shareholder proposals requiring disclosure of information on compensation consultants and disclosure of financial statements of bank subsidiaries. The Division voted against management proposals for exorbitant retirement bonuses, stock options, poison pills and director fees.

The Council also held an October 2006 discussion on corporate governance with John C. Coffee Jr., business law professor and Director of the Center on Corporate Governance at Columbia Law School. The discussion covered key policy issues, particularly in the area of executive compensation and corporate exposure to financial risk from environmental issues. Two new proxy voting guidelines were approved by the Council in February 2007: one guideline supporting the right of US shareholders for an advisory vote on executive compensation, and a second guideline supporting corporate initiatives that focused on a proactive approach to climate change.

Legislative Update

Divestiture

The Council and the Division worked with legislative leaders in fiscal year 2007 to reduce the fiscal impacts of a divestiture bill prohibiting state pension fund investment in certain foreign companies doing business in Iran.

Meanwhile, the Division maintains a growing list of companies ineligible for New Jersey investment under a Sudan divestiture law passed in 2005.

In support of the 2005 Sudan divestiture law, the Division sold qualifying holdings in 17 companies by May 2006, well ahead of the three-year deadline required by the act. Sales of these holdings totaled \$2.2 billion.

At the end of fiscal 2007, the list of companies ineligible for investment under the state's Sudan law had grown to 30 companies, including Alcatel-Lucent, Ericsson, Nestle and Sony. Some of this list's growth came from the addition of companies located in emerging market countries, as the Division expanded its investments in these countries. The list also grew with the addition of companies not currently in the Fund but newly identified as ineligible for investment because of their equity ties to the government of Sudan or its instrumentalities. Companies that qualified for removal from the ineligible list were fewer in number than those newly qualifying for the list in fiscal 2007.

Divestitures pose three primary fiscal challenges to pension funds: they require the identification and sale of holdings on a timetable that doesn't consider market conditions; they impact risk and return for the entire pension fund; and they permanently reduce the investment universe available to a particular fund.

The Iran divestiture bill, which was signed into law in January 2008, requires the divestiture of an estimated \$360 million in Pension Fund holdings by 2011, and further expands the list of companies ineligible for Pension Fund investment. Together, the Sudan and Iran divestiture laws reduce New Jersey's investment universe by almost 10 percent in developed markets and 14 percent in emerging markets, of its respective benchmarks. In addition, the Division's "prohibited" list includes an additional 45 companies which are not included in our international benchmark. The Iran divestiture law will receive full reporting in the fiscal year 2008 annual report.

Environmental Initiatives

The Division and Council took a more active role as institutional investors in fiscal 2007 in understanding and addressing the fiscal risks and opportunities posed by climate change and climate change regulation, in concert with the environmental leadership offered by the Legislature and Governor in drafting and adopting the Regional Greenhouse Gas Initiative, one of the nation's most progressive climate change laws.

Specific actions undertaken by the Division and Council included:

- Joined a growing list of major institutional investors in the Investor Network on Climate Risk (INCR), a \$5 trillion network of major investors that promotes better understanding of the financial risks and opportunities posed by climate change.
- Joined a "CEO Call to Action" seeking a mandatory national policy aimed at reducing greenhouse gases, released in April 2007 in Washington, DC.

Strengthening the Operation

Stakeholder Relations

The Council and Division undertook several initiatives in fiscal year 2007 aimed at increasing the transparency of investment policies and practices and strengthening relationships with key stakeholders. Specific initiatives included:

- **Voluntarily adopted personal financial disclosures by all State Investment Council members.** The Council by unanimous vote in February 2007 agreed to file by May 15 each year personal annual financial disclosures required by law of most other State boards and authorities.
- **Increased reporting on Pension Fund performance** by expanding the director's monthly report released publicly at each meeting of the State Investment Council beginning in December 2006, and by adding additional information relating to alternative investments to the Division's website.
- **Offered special briefings.** Council Chair Orin Kramer discussed pension fund shortfall and steps the Council was taking to address these liabilities before the New Jersey League of Municipalities in November 2006. Division Director William G. Clark presented a detailed history of Pension Fund performance and current planning to representatives of the public employee unions in September 2006.

Search for a Global Custodian

The Division partnered with the consulting firm Callan Associates in fiscal 2007 to identify the most cost-effective and efficient ways to consolidate today's multiple custodian services under a single global custodian for all funds except the Cash Management Fund.

A Request for Proposals summarizing the Division's needs for upgraded systems and processes was drafted, and was expected to clear internal state review in the 2008 fiscal year. By consolidating all custody under a single agreement, the Division should be able to negotiate improved economic terms for these services (i.e., lower custody fees);

streamline accounting and other back-office processes through interface with one custody provider; and obtain superior technological and operational support via a larger scope of services.

The Year Ahead

The Investment Plan adopted by the Council for fiscal year 2008 continues the course set by the fiscal year 2007 Investment Plan: Alternative investments will increase at the same pace as previous years, even though the allocation to alternatives will remain less than that of other large public pension funds. The Fiscal Year 2008 plan calls for a somewhat lighter allocation to equities, consistent with the market risks perceived in that class.

The FY 2008 Investment Plan also incorporates three long-term initiatives:

- **Leveraging the Fund's size** where appropriate to seek equity stakes in investment management firms, so that the Fund gains not only returns but shares in the manager's profits as well.
- **Partnering with other pension funds** to increase negotiating power in investments, particularly over fees. The Division will seek such partnerships with other U.S. public funds, foreign funds and endowments. Sectors of special interest are infrastructure and "sustainable investments" including alternative energy.
- **Contracting with a new, global custodian** to upgrade the investment tools and systems available to the Division. A request for proposals is expected to be ready for release in the second quarter of calendar year 2008. The move to a global custodian is expected to modernize and improve the efficiency of Division operations.

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