# Key Points and Issues
# For February 2008

## Director's Note

Even though we experienced another difficult month in world financial markets, we estimate that the pension fund portfolio was down only 0.43% for the month of February. While our overall views have not changed significantly from last month, the rapid decline in the value of the U.S. dollar caused us to take several steps to further reduce the risk level in the portfolio somewhat.

First, we continued to reduce our exposure to equities, particularly in the U.S. Net sales of U.S. and international equities in February were $555 million and $265 million respectively. In addition, we purchased put options and sold calls in late February and early March intended to protect against market declines on roughly $500 million in financial services stocks. Finally, we purchased an additional $370 million of international bonds, including $270 million of short term JGBs.

## Total Pension Funds

- Estimated performance for the pension funds for the fiscal year-to-date period is -1.89% versus -0.17% for the Council benchmark. For the month of February, the fund was down -0.43% versus 0.00% 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 February 29, 2008 were $77.7 billion.

- We were net sellers of $555.4 million of U.S. equities in February. In addition, we initiated a "collar" on roughly $500 million of U.S. financial services stocks by selling call option on a handful of individual names and purchasing put options on the XLF (an ETF consisting of the financial services stocks in the S&P 500 Index). Within the international portfolio, we were net sellers of $264.5 million of developed markets equities, but purchased $370 million of international bonds and $200 million of emerging markets equities. Within domestic fixed income, we were net sellers of $389.6 million, consisting mostly of short term U.S. agencies and corporates and long-term U.S. Treasuries.

- During February, we transferred $500 million out of domestic equities (Common Fund A) and $400 million out of domestic fixed income (Common Fund B). Offsetting these amounts were transfers of $500 million into international (Common Fund D) and $400 million into alternatives (Common Fund E).

**Domestic Equity**

- Performance for Common Pension Fund A for February was -2.52% versus -3.14% 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 -8.93% versus -10.58% for the benchmark. Our outperformance in February was primarily attributable to our underweight exposure to financial stocks and strong relative performance in the telecommunications sector.

- As stated above, net sales of equities within Common Pension Fund A during February were $555.4 million. While sales were spread throughout the portfolio, the major activity was in the financial, energy and industrial sectors. Within financials, we were sellers of AIG ($49.2m), J.P. Morgan Chase ($48.5m) and American Express ($23.m). Within energy, our biggest sales were in Exxon Mobil ($72.6m) and Devon ($21.6m). Finally, within industrials, the major sale was in General Electric ($127.9m).

- As discussed above, we initiated a collar position on abut $500 million of financial stocks, consisting of selling calls on a basket of individual names and purchasing puts on the XLF. Including our pre-existing puts on the overall market, we have put protection on roughly $1.3 billion of domestic equities.

- 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 112bp versus the index, up slightly from last month.

**Domestic Fixed Income**

- Performance for Common Pension Fund B for February was -0.09% versus -0.26% 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 9.45% versus 8.40% 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 (excluding TIPs) was 9.03 years (up from 8.81 years as of January 31) years as of February 29, 2008, versus 11.37 years for the Lehman Long U.S. Government/Credit Index.

- We had net sales of approximately $389.6 million in domestic fixed income securities in February. The major sales were in short-term U.S. agencies and corporates ($352.1m) and long-term U.S. Treasuries ($278.2). Offsetting these sales were net purchases of 10-30 U.S. corporate bonds, which we felt offered attractive value at current spread levels. Names that were purchased include

Alcoa, American Water, General Electric, J.P. Morgan Chase, McDonald's, Morgan Stanley and TVA.

**International Equity/Fixed Income**

- The equity portion of Common Pension Fund D returned 1.78% in February versus a 1.21% 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 -7.40% versus -7.80% for the benchmark.

- We were net sellers of $264.5 million in international developed markets equities in February. The major activity was in the telecommunications and materials sectors, where we tendered our stake in British water company Kelda ($95.5m) and sold $50.7 million of Yara International (a Norwegian fertilizer company).

- Within emerging markets we continue to transition the portfolio to our four external managers. During February, we transferred an additional $200 million to our externally-managed portfolio.

- We added $370 million to our international fixed income portfolio in February, including $275 million of short-term JGBs and $95 million of long-term bonds issued by the governments of Australia, France and the Netherlands.

- 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: Addax Petroleum Corp, Aquarius Platinum Ltd., Bunge, China Overseas Land, China Unicom Ltd., China Yurun Food Group, Denway Motors Ltd., Eurasia Natural Resources, Evraz Group SA, Golden Agri, Gome Electrical, Hengan International Group Co., Hopson, I-Shares MSCI Emerging Market Index, I-Shares MSCI Taiwan Index Fund, I-Shares BSE Sensex India Tracking, Investcorp Bank, Oriflame, Ports Design Ltd., Sinofert, Straits Asia Resources, Tenaris SA and Vimetco.

**Alternatives**

- During February, we funded $650 million of commitments to alternative investments, including $200 million to a newly-established commodities account managed by Gresham and $152 million to two bank loan funds managed by Oak Tree and BlackRock. We also closed and invested $75 million each in two new absolute return funds – Level Global and Pendragon.

- We estimate that our absolute return portfolio was up 0.20% for February. As discussed at last month's Council meeting, the main objective of the absolute return portfolio is to reduce the overall volatility of the portfolio. Given that U.S.

stocks were down -3.14% in February, we believe that the absolute return portfolio met that objective.

**Cash Management Fund**

- Total assets in the Cash Management Fund were $17.3 billion as of February 29, 2008. The current yield is 3.30% for state participants, and 3.20% for "non-State" participants. The yield continues to decline (both yields are down by 58 bp for the month) in response to recent Federal Reserve actions to reduce the target federal funds rate.