

State of New Jersey
State Investment Council

ANNUAL Meeting
Trenton War Memorial – Delaware Room
West Lafayette Street
Trenton, New Jersey 08608

Thursday, November 20, 2008
2:30 p.m.

MINUTES

Approved December 18, 2008

Present: Orin Kramer, Chair
Jonathan Berg, Vice Chair
Erika Irish Brown
W. Montgomery “Monty” Cerf
Jose R. Claxton
Susan Ann Crotty
Mark Kandrak
James C. Kellogg
Douglas A. Love
James P. Marketti
Timothy McGuckin

Absent: Jim Clemente

Also

Present: *From the Division of Investment:*
William G. Clark, Director
Ray A. Joseph, Deputy Director
Gilles Michel, Assistant Director
Brian Arena, Investment Officer
Linda Brooks, Senior Portfolio Manager
Susan Burrows Farber, Secretary to the Council
Betty Carr, Portfolio Manager
James Falstrault, Investment Officer
John Giovannetti, Cashier Manager
Jason MacDonald, Investment Analyst
Tom Montalto, Senior Investment Analyst
Christine Pastore, Investment Officer
Ainsley A. Reynolds, Accounting Manager-Alternatives
Tim Rollender, Investment Analyst
Susan Sarnowski, Compliance Officer
Amanda Truppa, Chief of Staff
Mary Vassiliou, Accounting Manager-International
Mike Wszolek, Trading Officer

From the Governor’s Office, Dept of the Treasury and Attorney General’s Office:
Joseph Donohue, Treasurer’s representative

From the Governor's Office, Dept of the Treasury & Attorney General's Office, con't:
Tom Vincz, Director of Communications
Rubin Weiner, Deputy Attorney General

Members of the Public:

Frederique Adam-Jupillat, LPS
Garrett S. Bagley
Tom Baldwin, *Gannett News Service*
Senator Bill Baroni (R), Hamilton Square
William S. Bauer, Jr.
Lateshia Belin, Taxation
Gloria Jean Berry
W. Michael Brindle, NJREA
Sharon Brooks, DOL
Linda L. Brown, DOL
Shirley Bryant, L&PS
Michael Calabrese
Gabriele Cantland, DOBI
Jose Cardona
Adam Cataldo, *Bloomberg News*
Shaunelle E. Clark, Revenue
Russell Coffey
Sandy Coia
Phyllis A. Coleman, Revenue
Clifford S. Cooper III, DOBI
Joseph Coppola, Jr., President Bergen County Education Assn
Barbara Counts, ELEC
Paul Curcio
Susan Deile, NJEA
Steven Dovidio, Revenue
Sharon Favice, DOBI
Marie Flynn
Diane Freeman, Treasury
Thomasine Gaines, Insurance
Steven R. Green, DOBI
Assemblywoman Linda R. Greenstein (D), Monroe
Harvey Grossman
J. Grossman, DOI
Ed Hannaman
Elaine Hanson
Nancy L. Hillman
Regina M. Jackson, Taxation
Deborah Jacobs
James Jameson, NJEA
Jacqueline Holmes Johnson
Lawrence Johnson
Sandy Johnson, MVC
Larisha Jones, Revenue

Members of the Public, con't:

Jerry Jones
Harvey Kelly, Leumas Advisors
Danniele Kinsey, Pension
Patricia Latimer
George LeBlanc, Senate Democratic Aide
Miguelina Lebron, Revenue
Lisa J. Logan
Bill Maloney, DOT
Wanda McEwen
Dusty McNichol, *The Star Ledger*
Mary Ann Mesics, DOE
Scharkner Michaud
Anthony F. Miskowski
Barbara Montgomery
Jerald Morris, NJSM
Clayton Mull, SCREA
Arun Murandhar
Anne M. Newman
Rodney E. Nichols, Staff Representative CWA Local 1033
John C. Onorati-Pascucci
Shameko K. Palmer, Revenue
Dale Parichuk, LPS
Gary W. Ponder
Angelo Principato
Lisa Radcliffe, MVC
Seth Robinson
Rae Roeder, President CWA Local 1033
Freddie L. Richardson-Guerra
JoAnn Richmond
Eula Rivers, MVC
John Ruth
Luz D. Sanchez, LBH
D. M. Sanders, DMV
Christine M. Smith
Paul Southard, DOT
Dianne Spence-Brown, Executive Vice President CWA Local 1033
Pat Stetler
Rodney Stevens
John Strachan
Leah Thomas, BME
Michelle Townsend, Taxation
Sheila Walker
Nellie Weathers
Raymond E. Weicker, DOBI
Devida Wells, Revenue
Karole Williams

I. *Call to Order*

Chair Kramer called the Annual Meeting to order at 2:25 p.m., following a recess at the conclusion of the Council's regular monthly meeting.

II. *Roles and Responsibilities of the Council, Division of Investment and Division of Pensions and Benefits*

Chair Kramer offered a brief explanation of the Council's role as an investment policy-setting body, and the Division's role as the investors and implementers of that policy.

He said it was clear that the country has been in a deep recession for a while, and at a minimum the recession would be more severe than any other in the past 25 years. He noted consumer confidence and retail sales were dropping in ways never experienced. He suggested the economy at large had not yet hit the bottom and that the nation was still in the early stages of a lending crisis and massive loan defaults, suggesting that defaults would hit levels not seen in the last 40 years. He said the credit markets would likely normalize some distance from where it had been, and the market's condition in 2006 and 2007 would not return in the foreseeable future.

Chair Kramer said extending pension fund diversification with alternative investments was not debated anywhere but New Jersey. He noted that history clearly showed New Jersey's pension fund returns would have increased current balances by many billions of dollars if it had diversified earlier. He said that many pension funds had performed especially well during the past decade because of large commitments to alternative investments, although he added that funds with exaggerated alternatives positions would also face issues in the current economic downturn.

Besides moving the Pension fund to greater diversification, Chair Kramer noted several other Council achievements.

In the area of corporate governance, Chair Kramer noted that historically the Division had rarely taken public positions in opposition to the positions of company management. He said this had changed in recent years as the Council became a more aggressive advocate for shareholder interests. As examples, he said, the Council publicly led calls for action in the ouster of the CEOs at Morgan Stanley and Sovereign Bancorp, and opposed the re-election of some board members and excessive executive compensation proposals at troubled financial institutions.

Chair Kramer noted that New Jersey's had been the only pension fund to testify in Washington in favor of higher taxes on earnings for hedge fund and private equity managers. He said the Council was the first to caution that the values of some private equity funds were overstated, and that this would become a visible public issue in the next six to nine months.

III. *Report from Pensions and Benefits*

Director Clark introduced Fredrick J. Beaver, Director-Division of Pensions and Benefits, to speak briefly on pension funding and benefits payments overseen by his Division.

Mr. Beaver said it was the Administration's responsibility to plan wisely against economic downturns such as the current one, even though there was little any state could do to correct such events. He noted that the New Jersey pension fund had never missed nor been late with a payment in the fund's history. He said that as of July 1, 2007, the fund had assets equivalent to 76 percent of its total liabilities, a number that while unsatisfactory left the state's fund in better position than many others. He said the actuaries who monitor fund assets focus on a 30-year cycle, and while the next update would likely reflect a lower funded status because of the economy it would not be dramatically different. He said the Division would like to see full funding and full contributions to the Pension fund, though in the current economic climate that would be difficult.

IV. *Objectives of the Council's Asset Allocation Plan*

Chair Kramer introduced Council Member Dr. Douglas A. Love as a distinguished and widely published scholar who had served as Chair of the Council's Investment Policy Committee for the past five years. Chair Kramer noted that today's public presentation to the Council was one of several Dr. Love had made on the issue of asset allocation.

A handout prepared by Dr. Love is attached to the official minutes as shared with the Council.

Dr. Love said that performance and returns are measures after the fact of investing, and that investors can exert influence only before the fact. All any investor can truly manage is risk, he said, and that defines what asset management is all about.

To reduce risk, he said, investors don't want to invest in just one asset class, or even two that are going to respond to market forces the same way. Wise investors use multiple asset classes to minimize the risk of loss.

The riskiest basket the Division manages is equities, he said, because of the historic volatility of equity markets. Bonds are the least risky, and compensate their investors accordingly. Among alternatives, he added, private equities are a form of stock and their volatility can be under-rated but they are a good class of investment for the additional opportunities they provide.

New Jersey's Pension fund historically invested only in public, domestic stocks and bonds. In more recent years, he noted, the fund moved first to international stocks and bonds, and then alternative investments in combination: private equity, real estate, hedge funds and commodities.

Analysis shows the diversification was a wise move, he said. The move to alternative investments was largely funded by a reduction in the fund's public equity holdings. By pretending that transfer had never happened, Dr. Love calculated that in the first six months of 2008 alone the alternative investment program had added \$1.3 billion in value to the Fund that wouldn't have existed if the larger investment in public stocks had been held. He said alternatives as a class had outperformed public stocks in this period, even though hedge funds within the alternatives class were down.

The current economic downturn lessens the impact of those first six months of performance, he said, but the point remains. Alternative investments have proven to perform independently of stocks with less volatility. That makes them valuable to any diversification, Dr. Love said.

In summary, asset allocation basically determines 95 percent of investment performance, he said. Diversification is more than academic when it drives 95 percent of a portfolio's performance.

V. *Report on Pension Fund Status and Fiscal Year 2008*

Director Clark provided a report on the pension fund's status and performance in fiscal year 2008, using the presentation attached to these official minutes.

Among the key points of his remarks:

- The history of market returns for the fund shows the benefits of increased diversification, as detailed by Dr. Love.
- The average hedge fund outperformed all equity markets around the world, even in a year when hedge funds were doing poorly by historical standards.
- The Council and Division had expressed concern publicly about excessive leverage in the economy and the financial system for more than a year, but were still surprised by the magnitude and speed of the credit market collapse
- The current economic decline marks only the fifth time in the last 200 years that the 10-year return on stocks has dipped to negative numbers. The silver lining, Director Clark said, is that the recoveries that historically follow such declines have been significant, although the Division is not yet calling a bottom to the current decline.
- New Jersey's Pension fund has been helped by a strong cash position this fiscal year, with reserves of 7 percent as of June 30, 2008, versus 1 to 2 percent for many other funds.
- The Fund performed strongly against public funds of similar size last year, placing in the top quartile. Some funds, notably Texas Teachers and CalPERS, had higher performance numbers because they invested a larger share of their assets in alternatives.
- The Fund has outperformed the market in each portfolio for the last three years, a remarkable feat by industry standards.
- The active management of investments by Division staff, compared with the indexed approach used by many other funds, resulted in an additional \$2.27 billion in value for fiscal year 2008, Clark said. That number is especially impressive given that the

Division only has 17 employees engaged in active investing, managing an average \$4 billion each.

- While he wished he “could take back the Lehman investment” made in June, Director Clark said, there were 13 other significant Division decisions that protected or enhanced the fund. These included an early withdrawal from asset-backed mortgages and no investments at all in areas that plagued other funds.
- The Division pays the lowest fees to outside management of most other major public funds.
- The wise investor can’t afford to pull out of any asset class entirely, Clark said, noting that the 10 best days of any year provide the majority of an investment’s annual upside return, and that these days are impossible to predict.
- Diversification makes sense when you consider that the yield for cash and Treasury bills, often considered to be the safest investment, is currently zero.
- As Americans, we need to remember we have options not available to many others and we can steer the right course through these times.

VI. Concluding Remarks

Chair Kramer asked Susan Ann Crotty of the Council’s Executive and Investment Policy committees to provide closing remarks.

Ms. Crotty said all hindsight was 20-20. To those who blamed the Fund’s fiscal year decline on diversification rather than market conditions, she noted that if the Fund had been invested entirely in Treasury bills it would still have experienced a decline in real value against inflation. She noted that the market was experiencing difficulties of historic proportions and that the current turmoil was “hopefully as close to the Great Depression as we will ever get.” She said pension fund investors have to keep a long-term perspective.

VII. Public Comment Period

Because of the number of registered speakers, Chair Kramer asked that speaker remarks be limited in time; after a brief discussion with some in the audience it was agreed the limit would be four minutes per speaker. The Secretary called on speakers in the order in which their requests to speak had been received by the Division.

Mr. Tony Miskowski asked about the Fund’s increased investment in alternatives over 2006 levels, where the performance of particular funds was published, and who monitored the performance of alternative investments. Director Clark said the increase to alternatives was summarized in the Division’s annual audit and could be included in regular financial statements going forward. He pointed out the performance of each fund is carried in Exhibit 25A of the monthly Director’s report distributed at each Council meeting. Mr. Claxton noted that in addition to the Division’s outside auditor, there is a separate auditor for every hedge fund to provide a third party valuation. Chair Kramer noted that it was not the Fund’s alternative investments that drove the recent declines, but the performance of “highly rated, highly regulated” public companies.

Mr. John Strachan objected to the Governor's proposal to earmark a portion of Pension fund investment to support banks doing business in New Jersey, and asked whether the Fund was encouraged to take risks to compensate for the State's failure in past years to provide employer contributions. Mr. Cerf said the Council's strategy had never included higher risks to make up for funding gaps. Director Clark said the Governor's proposal had not been clearly communicated, and that the program was designed to invest only in New Jersey banks where returns were competitive and the investments were fully guaranteed by the FDIC.

Mr. Clifford Cooper expressed concerns that the original 18 percent cap on alternative investments had been raised to 28 percent and would be raised again. Several Council members responded that the revised limit was adopted primarily in order to eliminate the need to sell alternative investments if the value of equities and other assets in the portfolio declined because of market conditions, putting the percentage of alternative investments near the legal maximum. The amount planned for total investment in alternatives had not changed.

Several Council members responded that the new limit accommodated the higher value of alternative investments as the value of equities and other assets in the portfolio declined because of market conditions, putting the percentage of alternative investments near the legal maximum. The amount planned for total investment in alternatives had not changed.

Dr. Steve Green asked how the Council could "know what it knows" in a financial system riddled with fraud. He also protested the Governor's plan to earmark investment for New Jersey banks, saying he saw no benefit for the Fund. Director Clark said the Division maintained cash funds from state and local government bodies that by definition required short-term investment; he said that the New Jersey banks were only be eligible for those investments if they provided rates as good or better than available elsewhere, with the complete protection of federal guarantees. Sue Crotty said it was relevant to question why banks weren't lending to each other but that it was a normal if "terrible" practice in every economic crisis. She said the primary focus of the new banking plan was to secure federal guarantees with better than average returns. Several Council members agreed that it was wise to be skeptical of information in today's environment.

Ms. Rae Roeder, president of CWA Local 1033, ceded her time to Senator Bill Baroni. Senator Baroni praised the Division for exploring the potential for misrepresentation by Lehman in its last investment. He said it was incumbent on the Legislature to make full pension payments.

Mr. Raymond Weicker asked how the Division could trust its risk models when the market wasn't following model norms. Director Clark said the goal was to invest in ways that reduced the downside risk if you were wrong, but allowed for as much upside bounce as possible.

Mr. William Bauer said he was concerned about a possible conflict of interest in the Lehman investment since two Council members are employed by Lehman and the company did business with the State. He also asked about the status of external mangers

engaged by the Division in light of the state court's recent decision that such engagements were not supported by current regulations. Chair Kramer noted the Council is not involved in investment decisions. Director Clark said the court had granted a 90-day stay in the implementation of its order regarding external managers, and that the Division planned to meet further with union parties in the lawsuit in developing a plan for compliance.

Dr. Maryann Mesics said she remained concerned about the decline in Pension fund assets from their \$84 billion level in August, asking at what point the Fund would reach a point of no return. Director Clark said the net monthly benefits payments from the fund were roughly \$400 million, and that the market would likely change again in the years before the fund was exhausted.

Mr. Paul Southard asked about the soundness of Pension fund numbers. Chair Kramer said the fund was reviewed annually by an outside auditor. Director Clark noted the Division had just changed auditors, and that the forthcoming report would be posted as usual to the Division's website.

Mr. Bill Maloney expressed concerns that the Pension fund was not fully funded by the State, and asked that the Council not permit the Fund to become a priority of last resort for the Legislature or the Administration.

VIII. *Council Comment/Summary*

Mr. Kandrak said he shared the funding concerns raised by the audience as he was a contributor to the Fund, too. He said it was ironic that some in the Legislature were calling for an accounting of investments by the Division but were not visible when state payments to the Fund were due. He said it was up to everyone in the room to let the Legislature know that the full employer payment was expected. He commended the Division and the Council for their dedication to the Fund and said as a firefighter, people have to put their faith and trust in him, and the public could do the same with regard to the Council, the Division and the fund.

Chair Kramer then recognized Assemblywoman Linda Greenstein, who urged the Division to invest with caution in these uncertain times. Mr. Berg challenged the Assemblywoman to lead a bipartisan effort that would require government employers, including the state, to provide full pension funding. The Assemblywoman said she would work willing with those interested in such a bill.

IX. *Next Meeting*

December 18, 2008

Noon: Lunch/1 p.m. Meeting

Rutgers Student Center
Multi-Purpose Room B
126 College Avenue, 1st Floor
New Brunswick, NJ 08901

X. *Adjournment*

With all business completed, the Council adjourned at 4:25 p.m. by unanimous vote on a motion by Mr. Cerf, seconded by Mr Claxton.

Respectfully submitted, Susan Burrows Farber, Secretary to the Council

State of New Jersey
State Investment Council

**SPECIAL MEETING at
State Pension Boards Meeting Room
50 West State Street, First Floor
Trenton, New Jersey 08625**

**Friday, October 31, 2008
9:30 a.m.**

MINUTES