October 29, 2008

MEMORANDUM TO: State Investment Council

FROM: William G. Clark
Director

SUBJECT: **Proposed additional Hedge Fund Investment in BlackRock Credit Investors Co-invest, L.P.**

This due diligence memorandum is presented to the State Investment Council (the "Council") pursuant to N.J.A.C. 17:16-69.9(a) to report on one proposed direct hedge fund investment of $144 million in the BlackRock Credit Investors Co-Investment Fund, L.P.

Please note that this investment will be authorized pursuant to Articles 69 and 100 of the Council's regulations. This investment will be considered a Credit Oriented Fund investment as defined under N.J.A.C. 17:16-100.1.

The Alternative Investments Procedures adopted by the Council on February 21, 2008 require any potential alternative investment opportunities to be identified and initially evaluated by applicable staff of the Division of Investment and the applicable Asset Class Consultant (Cliffwater LLC for direct hedge funds, or "Cliffwater"), in coordination with the Division of Investment's Investment Committee (Director, Deputy Director and senior hedge fund staff member).

Cliffwater and the Division staff undertook extensive due diligence on this proposed investment. We completed the same due diligence process as with all the other alternative investment opportunities presented to the Council.

Based on this due diligence, the Division has determined that this proposed investment meets the criteria for investments set forth in the Alternative Investment Procedures.

As you may recall, the Division presented a proposed $400 million investment in BlackRock Credit Investors Fund at the Council's September 2007 meeting. (Note: we have attached the original memorandum to the Council that discussed this investment). This investment was part of a broader strategy to invest in "bank loans" made by various commercial and investment banks to help finance corporate acquisitions. Because of dislocations in the credit markets that started in the summer of 2007, these loans started to trade at significant discounts to par value, thus offering attractive yields relative to other fixed income investments.

In order to help finance the purchase of these bank loans, BlackRock Credit Investors Fund utilized leverage as a means to improve expected returns for the Fund. The Fund's use of leverage (debt equals 2.1x equity) combined with an unprecedented fall in bank loan prices (along with market value declines of virtually all equity and fixed income investments) has created the need for additional investor capital to prevent a breach of its loan facility margin requirements. If that were to occur, the Fund would be forced to sell a portion of its bank loan investments, which we strongly believe would not be desirable given current market prices for these investments.

To put current market prices into perspective, bank loans by design are most senior in the capital structure of a company. In the event of a default, bank loan investors get paid in full before other bondholders and equity investors. Because of this, recovery rates on bank loans have historically been more than 80% in the unlikely (but not impossible) event of a default. Despite this protection, dislocations in the market caused by the "credit crunch" have resulted in bank loans trading between 70-75 cents on the dollar. We believed that bank loans offered good value last fall when they traded around 90 cents on the dollar – at current levels, we believe such investments offer the potential for unprecedented risk–adjusted returns.

In order to reduce leverage in Black Rock Credit Investors Fund, BlackRock has created a new fund called BlackRock Credit Investors Co-Investment Fund, L.P. The new fund will buy participatory shares in the BlackRock Credit Investors Fund. The BlackRock Credit Investors Fund will use these investments to reduce leverage and eliminate the need to sell any of its existing investments. Based on BlackRock's ability to raise this additional capital, they were also able to negotiate an improvement in terms for the remaining financing for the Fund. <u>The management fee and the performance fee for the new fund are waived</u>.

BlackRock has asked the investors in BlackRock Credit Investors to invest an additional 36% of each investor's original investment (with a goal of raising an additional $800 million), which for New Jersey represents $144 million in additional capital. We have been told that more than 80% of the investors in the Fund (including BlackRock, which has $100 million invested in the Fund) have already invested this additional amount. We invested $49.5 million on October 17, 2008 pursuant to Article 69 which permits the Division to invest up to $50 million in an investment without prior presentation to the Council. In order to obtain the full benefits of the improved financing terms, and to eliminate the need for BlackRock to sell any of these investments, we wish to invest an additional $94 million so that our total investment in BlackRock Credit Investors Co-Investment Fund, L.P. equals 36% of our investment in the original Fund.

A formal written due diligence report for the proposed investment has been sent to each member of the Investment Policy Committee of the Council coincident with this letter on October 29, 2008. After a review of the due diligence conducted on the fund, the Investment Policy Committee of the Council will report on the proposed investment to the full Council pursuant to Step 4 of the Alternative Investments Procedures. Under these procedures, the Council may adopt or otherwise act on this report.

<u>The SIC Investment Committee Fund Review Memorandum for the proposed investment will be sent to all Council members via email on Thursday, October 30, 2008.</u>

We will work with representatives of the Division of Law and outside counsel to review and negotiate specific terms of the legal documents to govern this investment. In addition, the proposed investment must comply with the Council's "pay to play" regulation (N.J.A.C. 17:16-4). While we are confident that we will work through these issues, the potential exists that a successful resolution will not be reached with this manager.

We look forward to discussing this proposed investment at the Council's October 31, 2008.

WGC/MK
Attachments