To the Honorable Governor, Legislators and State Treasurer and Citizens of New Jersey:

This Annual Report provides detailed information on the legal structure and oversight of the investment management of the State's Pension Fund, along with information on investment activity and performance for the fiscal and calendar year 2007.

The State of New Jersey maintains seven pension funds (collectively referred to in this report as the "Pension Fund") that provide retirement benefits to various public sector employees. The Pension Fund is intended to provide retirement benefits to more than 700,000 active and retired employees. This is a responsibility that we take very seriously.

While the State Investment Council and the Division of Investment are separate entities, they work together in order to manage these Pension Fund assets. Quite simply, the State Investment Council sets the investment policy for the portfolio, and the Division of Investment implements that policy. This letter discusses the recent changes made in the Council's investment policy and the investment results for the fiscal year 2007. Finally, we offer comments on changes in the investment environment occurring after fiscal year 2007 and how these changes have, and likely will, impact the portfolio.

"New Jersey was one of the first public pension funds to invest in U.S. common stocks. While critics of this approach viewed this shift as 'too risky,' this change positioned New Jersey as one of the top-performing funds."

<u>Changes to Investment Policy</u>

In the early 1980s, New Jersey was one of the first public pension funds to invest a significant portion of its portfolio in U.S. common stocks. While critics of this approach viewed this shift as "too risky," this change positioned New Jersey as one of the top-performing pension funds in the country for many years. In 1991, the Council took another innovative, yet controversial step – authorizing investment in international stocks and bonds. In doing so, the Council sought to achieve two important objectives: to capitalize on the potential for strong economic growth outside of the United States, and to diversify the portfolio (i.e., reduce the risk level) by adding a new asset class that would not necessarily move in tandem with U.S. equities.

Helped by a long-term bull market (which was spurred by a multi-year decline in inflation and interest rates, among other things) the Division's strategy led to strong investment returns for many years. In fact, from 1995 to 1999, New Jersey's pension plan returned an average of 27.96 percent per year, ranking it among the top of all public pension funds during that period.

However, after leading in strong investment returns and reducing fund risk by diversifying its portfolio with new asset classes, New Jersey opted to stay the course and hold its asset allocation constant, rather than move into newer asset classes, such as private equity and real estate. With the bursting of the "internet bubble" in late 2000-2001, the S&P 500 lost 12.8 percent and16.5 percent for the period from July 1, 2000-June 30, 2001 and July 1, 2001-June 30, 2002, respectively. During these two fiscal years, New Jersey's portfolio was down 9.0 percent and 10.4 percent, respectively, resulting in net investment loses during those years of $8 billion and $6 billion.

While it is not always advisable to compare ourselves with other public funds, there can be no argument that other funds, most of which continued to diversify into other asset classes, have significantly out-performed New Jersey on a risk-adjusted basis over five-, 10- and 15-year periods – and that performance was attributable to superior asset allocation policies. While New Jersey had solid relative performance in each of its major portfolios during that period, New Jersey's performance was in the bottom quartile relative to other public funds according to a 2007 national Public Fund Universe Report by R. V. Kuhns & Associates.

"Other public funds…which continued to diversify into other asset classes...outperformed New Jersey…the Council's conclusion was that the plan's asset allocation needed to be adjusted."

Starting in 2003, the State Investment Council began to re-evaluate the plan's asset allocation, undertaking the plan's first asset/liability study in nearly 25 years. Following multiple studies by independent consultants, the Council's conclusion was that the plan's asset allocation needed to be adjusted, and starting in the fiscal year ending on June 30, 2006, the Council made several adjustments to the portfolio's asset allocation. The major changes adopted include the following:

- A significant reduction in the allocation to domestic equities to reduce risk, while slightly increasing the allocation to international equities, particularly equities domiciled in so-called emerging markets countries, which as a group is expected to experience stronger economic growth than domestic markets.

- Initiating investments in private equity, the only new asset class in the portfolio expected to out-perform public equities over the long-term. The target allocation for private equity on an invested basis is 5 percent by 2010-2012.

- Initiating investments in real estate, with a target allocation of 4 percent by 2010-2012.

- Initiating investments in hedge funds as a means to generate positive returns that have a low correlation to public equities. The current target for the hedge fund portfolio, which is diversified by investment strategy, is 6 percent of assets.

- Initiating an inflation-sensitive portfolio as a means to hedge the Pension Fund against any potential increase in inflation in the U.S. As you may know, inflation is a major risk in a pension fund like New Jersey's where benefits are initially set as a percent of an employee's final average salary (which is indirectly influenced by inflation), and benefit payments are adjusted upwards by a percentage of the Consumer Price Index (CPI). The portfolio's desired allocation to inflation sensitive assets includes a 4 percent allocation to commodities and other real return assets (e.g., timber, infrastructure) and a 3 percent allocation to U. S. Treasury Inflation Protected Securities (TIPS).

- In recognition of the fact that the plan's liabilities are long-term in nature, we've sought to extend the duration (i.e., the average maturity) of the fund's fixed income portfolio from roughly five to more than 10 years.

Based on theoretical expected returns for each asset class in the portfolio, these changes are not designed to necessarily result in significantly higher returns for the portfolio. Rather, we expect to generate *comparable to slightly higher* returns than the former portfolio, but with a significantly lower level of risk (i.e., volatility of returns).

"We expect (these changes) to generate comparable to slightly higher returns than the former portfolio, but with a significantly lower level of risk."

Investment Results for Fiscal Year 2007

We are pleased to report that the portfolio's performance for the fiscal year ended June 30, 2007 was 17.1 percent, which exceeded our portfolio benchmark of 15.6 percent. More importantly, the Investment Division's performance in each of the four major portfolios – domestic equity, domestic fixed income, international equity and money markets – all exceeded their respective benchmarks for the fiscal year.

We briefly touch on the results and activity in each portfolio below. For more detailed information about each portfolio, please review the information and financial statements that follow this letter in the Annual Report.

***Domestic Equity*:** Performance for this portfolio (Common Pension Fund A) was 21.0% for the fiscal year, versus 20.2% for the S&P 1500 Composite Index, the benchmark for this portfolio. The main factors contributing to our out-performance were superior stock selection within the technology sector and underexposure to commercial banks and thrifts in the portfolio.

For the fiscal year, we had net sales of nearly $10.8 billion throughout the portfolio. These funds were used to make investments in other areas of the portfolio (primarily alternative investments) and to make benefit payments to retirees from the various pension plans.

As of June 30, 2007, the domestic equity portfolio had a market value of $31.5 billion, representing 38.3% of the overall portfolio. While the portfolio is broadly diversified across all economic sectors, the portfolio composition incorporates several major deviations from the overall market. In particular, the portfolio was underexposed to the financial services (discussed below) and consumer discretionary sectors, while having a higher exposure than the overall market to the energy and technology sectors.

***Domestic Fixed Income*:** This portfolio underwent a major transition, with its overall duration being extended from roughly five to nearly eight years during the fiscal year. Portfolio performance for the fiscal year was 5.2 percent, versus 4.4 percent for the Division's benchmark for the year (which was a blend of the Lehman Government/Credit Index and the Lehman Long Government/Credit Index).

"The portfolio's performance for the fiscal year ended June 30, 2007 was 17.1 percent, which exceeded our portfolio benchmark of 15.6 percent."

The market value of the portfolio as of June 30, 2007 was $20.9 billion. While the portfolio is well diversified, we made a conscious decision to be underexposed to corporate bonds, particularly those with credit ratings of BBB/Baa (the lowest ratings within the "investment grade" corporate bond market). In lieu of holding corporate bonds, the portfolio was overexposed to U.S. Treasury securities and mortgage-backed securities guaranteed by either the U.S. Government (i.e., GNMAs) or one of the government-sponsored enterprises (GSEs, meaning either the Federal National Mortgage Administration or the Federal Home Loan Mortgage Corporation). Please note that the portfolio had no ownership of securities backed by sub-prime mortgages.

***International Equity*:** The portfolio returned 28.5 percent for the fiscal year, versus 27.3 percent for the MSCI-EAFE index adjusted for those issues that are not eligible for purchase under the State's Sudan divestment law. The much stronger returns for international equities were partially attributable to a decline in the U.S. dollar relative to other foreign currencies (particularly the Euro).

Net purchases for the fiscal year were $758 million, consisting primarily of stocks in the consumer staples sector. As of June 30, 2007, the portfolio was overexposed to stocks in the media, luxury goods, machinery and infrastructure industries. The portfolio was underexposed to stocks in the commercial banking, metals/mining, telecommunications/utilities industries.

***Money Market*:** The State of New Jersey's Cash Management Fund returned 5.47 percent for the year, versus 5.06 percent for 90-day U.S. Treasury bills (the benchmark for the Fund).

As of June 30, 2007, the portfolio had a yield of 5.2 percent, with an average maturity of 62 days. The portfolio consists predominantly of bank certificates of deposit and U.S. Treasury bills.

***Alternative Investments*:** While performance statistics for an alternative investment portfolio in its early stages of development are not terribly valuable given their limited history, we note that the net returns (after fees) for the three major asset classes within the alternatives portfolio were as follows: 13.7 percent for private equity, 16.5 percent for real estate and 13.2 percent for hedge funds.

For private equity, the Division announced commitments of $4.8 billion through June 30, 2007 to 47 different partnerships. The actual amount invested in the program through June 30, 2007 was $1.1 billion. While the portfolio is well-diversified by investment strategy, we have attempted to de-emphasize the large U.S. buyout funds and to concentrate on debt-oriented strategies and international buyout funds.

"Net returns (after fees) for the three major asset classes within the alternatives portfolio were 13.7 percent for private equity, 16.5 percent for real estate and 13.2 percent for hedge funds."

Within real estate, we announced commitments of approximately $2.6 billion to 33 different partnerships as of June 30, 2007. The actual amount invested through fiscal year-end was $900 million. While the portfolio is also well-diversified by strategy, we have de-emphasized core real estate (given concerns about excessive market valuation) and instead have sought opportunities in opportunistic strategies in the U.S. and international real estate.

For the hedge fund portfolio, we announced commitments of $2.8 billion to 24 different funds, with actual investments of $2.3 billion as of June 30, 2007. While the portfolio initially concentrated on investing in fund of funds strategies (a fund managed by an investment advisor that invests in a number of underlying hedge funds), over the past year the Division has sought to make direct investments in a number of top-performing funds.

Discussion Of Subsequent Developments in the Financial and Equity Markets

For some time, the Council and Division had been concerned that the financial markets were mis-pricing risk across a wide range of financial assets. This concern was made evident by the historically low-risk premia embedded in the market values for structured financial products, corporate bonds, certain equity securities (particularly those in the financial services sector), and emerging market equities and debt.

The cause of this mis-pricing is still being debated in financial circles. Many experts believe that unsustainably low short-term interest rates in the U.S. created an environment where investors had incentive to reach for higher returns in a variety of higher-risk securities. The large U.S. current account deficit, coupled with the high savings rates of many of our trading partners, has resulted in large and growing accumulations of wealth held by foreign governments and private institutions. This large growth in liquidity no doubt contributed to a general re-pricing of certain asset classes as well.

As the demand for debt instruments offering higher yields grew, the U.S. financial services sector responded by growing new bases of borrowers and creating new types of financial instruments. The largest debt creation came in the U.S. mortgage market, where new products were designed to make home ownership possible for a new class of borrowers – those with inferior credit histories and/or speculators in real estate. The other major type of debt was in the form of “leveraged loans,” or loans to private equity funds to finance leveraged buyouts of various businesses around the world. Since most of this debt was in the form of variable-rate loans with interest rates tied to short-term interest rates, borrowers were able to finance abnormally large levels of debt. In the housing market, the assumption was that when rates on mortgages reset to higher levels, the borrowers could refinance based on further home price appreciation.

“Because of our concerns about (structured financial products…especially in the mortgage area)… we took prudent steps to minimize our exposure to the potential unwinding.”

New types of structured financial products allowed the financial services sector to package this debt into securities that could be sold to investors around the globe. Especially in the mortgage arena, securities were created en masse with credit ratings that were not (in hindsight) reflective of the true creditworthiness of the underlying collateral. Because the banks, brokers and other entities that originated these loans had no intention of keeping the debt on their balance sheets, there was inadequate attention paid to credit standards and/or risk management principles associated with these new forms of debt. This was an accident waiting to happen, and it did.

Because of our concerns about these trends, we took prudent steps to minimize our exposure to the potential unwinding of these excesses. The portfolio did not have any exposure to the various securities and debt held by many other pension funds that have re-priced and experienced significant market value losses in recent months: CDOs, CLOs, sub-prime mortgages, leveraged loans, asset-backed commercial paper. We also were significantly underexposed to stocks in the financial services sector, particularly those of commercial banks and thrifts that were most tied to the growth in the sub-prime mortgage market. Finally, our fixed income portfolio was significantly under-exposed to corporate bonds in general. The Division believed that spread levels (i.e., the incremental yield over U.S. Treasuries of comparable maturities) had become too narrow.

As of the date of this letter, worldwide investment losses that have been announced by financial services companies are approaching $300 billion. We suspect that ultimate losses will be significantly higher. In order to maintain their franchises, many financial services firms have raised additional capital from investors. The major investors in these issues have been sovereign wealth funds, but our pension fund has also participated in several of these transactions where terms were attractive. In addition to raising capital, these financial services firms have sought to improve their financial strength by curtailing new lending, even to creditworthy borrowers that have historically had little difficulty receiving credit. This has caused economic growth to slow, raising the likelihood of a recession.

In fact, the difficulties faced by financial institutions, along with rising energy prices and other factors slowing economic growth, have resulted in a weak equity market in fiscal year 2008, with expected returns for this fiscal year projected to be much weaker than in fiscal year 2007.

"The difficulties faced by financial institutions, along with rising energy prices and other factors slowing economic growth, have resulted in a weak equity market in fiscal year 2008."

What does all this mean for our performance and investment strategy going forward?

While we will remain cautious about the potential for additional systemic risk, we believe the unwinding of this credit bubble presents excellent investment opportunities for us. As mentioned above, we expect to continue evaluating opportunities to participate in the recapitalization of the global financial services sector. Given our size and continued underexposure to the financial services sector, we are well positioned to take advantage of the favorable investment terms offered by various recapitalization opportunities.

In addition, the curtailment of new lending by various financial institutions opens up opportunities for new capital to realize attractive risk-adjusted returns by picking up the slack. Given the size of our portfolio, and our ability to forego liquidity given the long-term nature of our pension liabilities, we expect to seek out multiple opportunities to lend and invest that were traditionally absorbed by the financial services sector. To date, we have committed capital to invest in leveraged loans and distressed mortgage-backed securities on extremely attractive terms, and are actively considering opportunities to also invest in newly originated commercial mortgages and other financing opportunities. On a broader level, we will seek to leverage our potential access to direct investment opportunities on a financially attractive basis.

While it will likely take many years to assess the impact of recent events on the financial services sector, we strongly believe that the sector will continue to shrink in importance in relation to the overall economy, and that will create new opportunities for us to realize attractive returns and to further diversify the portfolio into asset classes that were previously unavailable to us.

Our investment plan for FY2008 includes several new long-term initiatives that we believe represent excellent investment opportunities for us. First, we intend to commit funds over time to “sustainable investments,” with a potential focus on alternative energy opportunities. There are several general partners in the marketplace this year with excellent track records in this area. Given the political initiatives to reduce greenhouse gas emissions and the effectiveness of new technologies in this area, we believe that commitments to alternative energy projects offer the potential for exceptional risk adjusted returns.

Second, we will consider strategies that allow us to obtain equity stakes in general partners across all components of the alternative investments portfolio. The size of New Jersey’s investment capital and the reputation benefits associated with an investment by New Jersey make us an attractive partner for some managers looking to grow (regardless of their size).

“Our investment plan for FY2008 includes several new long-term initiatives that we believe represent excellent investment opportunities for us.”

Finally, we will seek opportunities to invest directly with other institutional investors as a means to influence product design and terms offered by general partners within the alternatives space. We will seek to identify opportunities where we can work with other public funds, endowments, foundations and sovereign wealth funds to structure investment programs within our various asset classes.

Sincerely,

Orin S. Kramer	William G. Clark
Chair	Director
State Investment Council	Division of Investment

June 1, 2008