

Agenda Item 1(a)

Minutes of the Regular Meeting

**Held October 21, 2010 at 1 PM in the State Museum Auditorium
205 West State Street, Trenton, New Jersey**

Council Members in Attendance:

Robert Grady, chair
Nicholas Caprio, vice chair
Jeffrey Oram
Andrew Michael Greaney
James C. Kellogg
Timothy McGuckin
James P. Marketti
Orin Kramer
Richard Klockner
Guy Haselmann
Brendan Thomas Byrne, Jr.
Marty Barrett *via teleconference*

The Regular Meeting was called to order by Chair Grady at 1:03 p.m.

Roll Call and Meeting Notice

Secretary Adams performed roll call and reported that notice of the Regular Meeting scheduled for October 21, 2010 was sent by mail deposited in the post office, by facsimile and email on September 30, 2010. A copy of the notice was posted in the Division on September 30, 2010, mailed to the Council, Times of Trenton, Star-Ledger, Bergen Record, and Courier Post on September 30, 2010 and filed with the Secretary of State on September 30, 2010.

Presentation on the Fiduciary Duty of the Council

Chair Grady welcomed new members Tom Byrne and Guy Haselmann to the State Investment Council.

Chair Grady stated that the members of the State Investment Council act as fiduciaries for the pension fund. Since there are many new Council members, he felt that it would be appropriate to have the Division's general investment consultant, Strategic Investment Solutions make a presentation to the Council members on their role and responsibility as fiduciaries.

DAG Rubin Weiner reviewed the Council's obligations under New Jersey statute and regulations.

Barry Dennis from Strategic Investment Solutions, discussed the role and concept of fiduciaries, the duty of loyalty and duty of prudence, prudence standards and the need for strong governance. A copy of the presentation is on file in the Division.

Director Walsh reviewed the New Jersey Pension Fund Membership Overview to provide the Council members with some context of the breadth of the funds managed by the Division.

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Director's Report

Memorandum "Investment Reports" dated October 15, 2010

Director Walsh stated that the markets were up in September, with the S&P 1500 having its best September since 1939, with the international markets performing even better. Overall, the Fund was up 4.19% for September, with the Council benchmark being up 4.13%. The Fund value as of August 31 was \$70.2 million.

Brian Arena stated that August was a strong month for domestic equities, with the S&P being up 9.21% versus the portfolio being up 9.41%. He attributed the fund's strength to the overweighted technology sector. The portfolio is up 11.68% fiscal year-to-date, with the benchmark being up 11.39% over the same period. For the calendar year-to-date, the portfolio is up 5.16%, versus the benchmark being up 4.67%. During August, there were \$412 million in net equity sales.

Tim Patton stated that the Division continued to take profits on spread products and use the proceeds to purchase new issues. The Division was a net seller of \$15 million in domestic fixed income, consisting of purchases of \$438 million and \$453 million in sales. The sales resulted in a \$32 million gain. For the month, the high grade portfolio was down 0.38% versus the index being down 0.71%. For the year, the portfolio was up 15.85%, although still underperforming the index, which is up 16.69%.

With respect to the High Yield portfolio, the portfolio was positive 1.13% versus the index being positive 3.01%. Calendar year-to-date, the portfolio was up 9.21% versus the index's gain of 11.53%. Mr. Patton reported that the Division's TIPS portfolio was up 0.48% versus the index being up 0.60%. Calendar year-to-date, the portfolio was up 11.61% versus the index's gain of 7.00%.

Gilles Michel stated that the September performance for the International Equity portfolio is up 9.29%, slightly underperforming the benchmark, which was up 9.88%. Europe performed well, adding almost a 5% positive contribution to September's performance. Financials and Industrials were the largest positive sector contributors.

Director Walsh advised the Council of the transition to a single global custodian and its ongoing effect on performance reporting.

Chair Grady thanked the Division for being responsive to his request to provide more information on the alternative investment schedules. Vice Chair Caprio sought clarification on several items on the alternative investment schedule.

Review of Fixed Income Portfolio/News Clips

Director Walsh stated that the Division's Domestic Fixed Income portfolio (excluding High Yield), yields 4.36% with an 11.84 year duration. He complimented Council Member Kramer and former Council Member Love for their efforts in advocating for extending the duration and changing the benchmark to the Barclay's Capital U.S. Long Government/Credit Index.

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Chair Grady discussed the historically low interest rates and asked about the risk of increasing interest rates and if there was a strategy toward shortening the duration. Tim Patton responded that the Division is already running shorter duration on bonds.

Council Member Kramer thanked Director Walsh for his kind words on the record and stated that he agreed with the Chair on bond strategy.

Director Walsh discussed yields across fixed income asset classes and explained that if interest rates went up 100 basis points, it would result in a Treasuries loss of \$329 million and TIPS loss of \$492 million. The estimated loss to the entire portfolio would result in a \$2.5 billion loss. If the interest rates rose 200 basis points, it would result in a \$4.5 billion loss to the entire portfolio.

Director Walsh also briefly discussed the news clips and stated that this period was reminiscent of the 1998-1999 bubble. Chair Grady mentioned that one of the clips discussed the Federal Reserve's intervention in purchasing Treasuries and that this intervention is one of the things that is keeping interest rates at these historically low levels.

Vice Chair Caprio said that he had read an article last week that mentioned how private pension plans are getting away from investing in the stock market to fixed income and alternative investments. He also had a question about cost shown on the investment schedule, which was clarified by Director Walsh.

Other Funds We Manage

Director Walsh briefly discussed the funds managed by the Division, including the Cash Management Fund and other assorted smaller funds and advised the Council that the Division was working to develop more structure around these funds.

Council Member Oram asked Director Walsh if he had any observations or impressions about how the Division stacks up against other pension funds and if he had any recommendations about the Division. Director Walsh stated that New Jersey operates differently than other large public pension funds, which tend to outsource most investments. He also said that the Division has some select staff that are highly skilled but there is not a great deal of depth organizationally.

Proxy Voting Update

Memorandum "FY2010 Summary Proxy Voting Report" dated October 21, 2010

Compliance Officer Susan Sarnowski advised the Council of the proxy voting guidelines and the Division's proxy voting.

The Division voted on 1,225 proxies of U.S. companies, voting with management on 668 of the proxies. Of the remaining 557 proxies, it voted against management on 815 individual proposals, typically on issues of "say on pay" or proposed stock option plans to prevent dilution. There were no new areas on the domestic side. On the international side, the Division voted 997 proxies, voting with management on 614 of the proxies. Of the remaining 383 proxies, it voted against management on 929 individual proposals. The Division is also monitoring

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implementation of the Dodd-Frank Act. Compliance Officer Sarnowski said that there is a report of every proxy vote available to interested Council members.

Audit Committee Report

Council Member Kellogg advised that the State was anxious to have the financials completed by December 1 and the Division was endeavoring to have the financials done by November 1. The management letter did not contain any significant findings. Director Walsh thanked the members of the audit committee for their hard work.

Proposed Additional Hedge Fund Investments

Memorandum "Proposed additional investments to existing Hedge Fund investments in King Street Capital, L.P. and Davidson Kempner Institutional Partners Fund, L.P." dated September 13, 2010

Tom Lynch of Cliffwater, the Division's hedge fund consultant, advised the Council that the Division was proposing to commit \$50 million in additional capital to both King Street and Davidson Kempner. Currently, the Division has invested \$143 million with King Street and \$125 million with Davidson Kempner. The commitment of additional capital will bring the totals up to \$193 million and \$175 million respectively.

King Street has a distressed strategy and they utilize a long/short approach. They are headquartered in New York, with almost 180 employees and \$20 billion in assets under management. The performance has been strong, with 10.4% annualized return for the portfolio.

Davidson Kempner has an event-driven strategy, investing in merger and convertible arbitrage strategies. They were formed in 1983 with 170 employees and \$14 billion in assets under management. They have produced a 6.4% annualized rate of return for the portfolio.

Chair Grady emphasized for the Council that these are additional investments in current hedge funds. He also stated that the Investment Policy Committee did not have any concerns about these investments and felt that proper and adequate due diligence was conducted by the Division.

Council Member Haselmann asked about the amount of ongoing due diligence. Mr. Lynch replied that ongoing due diligence was done at three levels: investment, operational and legal. Investment due diligence is conducted on a monthly basis. Full operational and legal due diligence is conducted annually.

Council Member Marketti asked about the side pocket for the King Street hedge fund. Mr. Lynch advised Council Member Marketti that a side pocket represents a portion of the pool of investments that cannot be readily priced and requires a third-party valuation.

Council Member Kellogg asked where the partnerships were incorporated. Mr. Lynch advised that both partnerships were based in the Cayman Islands.

DAG Weiner advised Chair Grady that regulations require that the investments be presented to the State Investment Council; however, they do not require a vote on the investments. Council Member Marketti stated on the record that he is opposed to both investments.

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Proposed Real Asset Investment for U.S.-based Oil and Gas Partnership

Memorandum "Proposed Investment in Sheridan Production Partners II, L.P." dated October 15, 2010

Christine Pastore, Co-Head of Alternative Investments, stated that this opportunity was sourced approximately 3 years ago through the Division's relationship with Warburg Pincus. Sheridan is an affiliate of Warburg Pincus and the company employs an exploration and production ("E&P") strategy by purchasing mature oil and gas fields. The Division invested \$50 million in Fund I and performance has been extraordinary. The Division is expecting 13-15% net IRR and is proposing to invest \$100 million.

Harshal Shah of Strategic Investment Solutions provided an overview of the fund, discussing the Sheridan management team expertise and fund strategy. Mr. Shah advised the Council that Sheridan management is also committing significant capital to the fund and that other large public and private institutional investors are also committing capital to Sheridan Production Partners II.

Council Member Kellogg asked if Warburg Pincus was also acting as a co-General Partner for this investment. Ms. Pastore stated that Warburg Pincus would have 40% ownership and Sheridan would have 60% ownership in the General Partner. In the first fund, the ownership split was 50-50 between Warburg Pincus and Sheridan. Director Walsh also commented that Sheridan management had significant capital invested and that from a fiduciary perspective, it was important to see ownership interests aligned with the investors.

Proposed Regulatory Changes to Increase Alternative Investment Asset Allocations

Memorandum "Proposed Amendments to N.J.A.C. 17:16-69, 71, 90 and 100 regarding Common Pension Fund E, Real Assets, Private Equity and Absolute Return Strategy Investments" dated October 15, 2010

Chair Grady advised the Council that proposed regulatory changes to increase the alternative investment asset allocations had been drafted by the Division. Director Walsh stated that the aggregate investment allocation ceiling is proposed to be raised from 28% to 38%. Chair Grady said that currently the actual allocation for alternative investments is just below 16%, compared to the target of approximately 19%.

Compliance Officer Sarnowski stated that these proposed regulations merely provide flexibility to the Division and that the regulatory process is arduous and typically takes a minimum of six months to adopt regulatory changes. Ms. Sarnowski stated that the proposed changes increased Real Estate potential allocation ceilings from 7% to 9%, Private Equity from 7% to 12% and Hedge Funds from 7% to 15%, and maintained Real Assets at its current 7% level, with a maximum aggregate cap of 38%. Minor clarifying changes were made after the Investment Policy Committee meeting.

Council Member Barrett sought clarification about the nature of the vote. Chair Grady stated that, in his opinion, this was a prudent recommendation to increase the Division's flexibility and

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that this is not a change in investment strategy or investment allocation. He also stated that the Investment Policy Committee met and made minor changes and the Committee felt comfortable with the proposed regulatory amendments.

Council Member Kellogg stated that he was voting against the proposed regulatory changes because he felt that there was currently sufficient flexibility in the alternative investment program. He noted the diminished rights of Limited Partners in offshore jurisdictions and repeated his views on hedge fund hurdle rates.

Chair Grady asked Division staff about the current amount of flexibility in the alternative investment asset classes. Director Walsh stated that private equity was already against the 7% cap. Chair Grady asked Ms. Pastore where the majority of funds were domiciled. She advised Chair Grady that she would provide him with that information.

Council Member Haselmann commented on the use of Cayman Islands as a hedge fund domicile and objected to the idea that general partners take advantage of limited partners by using offshore corporations. He stated that the Cayman Islands have developed international standards and that the implementation of a proper due diligence process prevents limited partner abuse.

Chair Grady asked the Division about the ability of limited partners to remove general partners. Director Walsh advised Chair Grady that the Division is on most advisory boards for private equity and real estate and that limited partners generally have the ability to remove general partners for cause.

Council Member Marketti expressed concern about management rights clauses in the Division's hedge fund contracts.

Council Member Byrne felt satisfied that there are adequate safeguards built into the process and that the difference between authorization and actual investment should be appreciated. He said it was important for the Division to have flexibility to be opportunistic. In addition, he commented that there should be further exploration of negotiating lower fees and hurdle rates. He was supportive of the proposed regulatory changes.

Council Member Klockner agreed with the proposed regulatory changes and stated that he would not have been comfortable with a 43% aggregate cap but supports the proposal with a 38% cap.

Council Member McGuckin also stated that he would not have been comfortable with the higher cap but agrees with the proposal.

Vice Chair Caprio stated that he believed that the proposal was a necessity but voiced concern to the Division about the ongoing monitoring of non-domestic entities. Director Walsh stated that the alternative investment staff maintains ongoing communications with the managers.

Council Member Kramer asked Director Walsh to address the regulatory changes from a risk management perspective. Director Walsh stated that he would feel more comfortable having the alternative investment flexibility as proposed.

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Council Member Oram motioned to approve the attached resolution. The motion was seconded by Council Member Haselmann. A roll call vote was performed, with the motion carrying on a vote of 9-2 with one abstention. Council Members Kellogg and Marketti voted against the resolution and Council Member Barrett abstained.

Communications

There was no report from the State Treasurer.

Chair Grady thanked Dr. Douglas Love for his excellent service and level of sophistication as member of the State Investment Council.

Public Comment Period

Bill Bauer expressed concerns about the fiduciary duty of the Council and commented on the State's lack of pension contributions. Chair Grady made a clarifying point in response to Mr. Baurer's comments by stating that the State Investment Council has nothing to do with State pension contributions, which is negotiated between the Governor and Legislature.

Thomas Buckley commented that investing in alternative investments is a questionable course of action and asked the Council to go slow in alternative investments.

Deborah Cole asked about hedge fund performance and whether the State would make more money in other asset classes. Chair Grady advised that there was hedge fund performance data contained in the Investment Reports and stated that the hedge fund portfolio was worth 6% more since the beginning of the program.

Rae Roeder asked about the minutes of the September meeting and was advised that the minutes would be forthcoming. She also articulated concerns about the effect of a new global custodian on the Division's accounting staff.

Adjournment of Meeting

Chair Grady motioned to adjourn the meeting. Council Member Marketti seconded the motion.

The meeting was adjourned at 3:43 PM.

Respectfully submitted,



Kaitlyn J. Adams
Secretary to the Council

**Resolution Approving Proposed Amendments
to N.J.A.C. 17:16-69, 71, 90 and 100 Regarding Common Pension Fund E,
Real Assets, Private Equity and Absolute Return Strategy Investments**

BE IT RESOLVED THAT:

The State Investment Council (the "Council") hereby approves proposed amendments to N.J.A.C. 17:16-69, 71, 90 and 100 regarding Common Pension Fund E, Real Assets, Private Equity and Absolute Return Strategy Investments.

The Council hereby authorizes the Director of the Division of Investment to submit the attached proposals to the Office of Administrative Law for publication and public comment, and hereby delegates to staff of the Council and the Division of Investment the authority to make revisions to the proposals as required and as shall be made upon the advice of the Attorney General.

This resolution shall take effect immediately.

DATED: October 21, 2010