

Key Points and Issues For December 2008

Director's Note

Signs of stabilization began to emerge in the financial markets in December. In response to continued aggressive steps by the Federal Reserve to stimulate the economy, interest rates in the U.S. declined significantly and spreads (i.e., the incremental yield over U.S. Treasury securities) for corporate bonds and mortgage-backed securities started to shrink. The portfolio was extremely well-positioned for these events, given our large purchases of investment grade corporate bonds in October-December.

Overall performance for New Jersey's pension fund was up +6.31% for December 2008, with the fund having an estimated portfolio market value of \$63.9 billion. This represents a \$3.3 billion increase in market value from November 30, 2008. The performance on our domestic fixed income portfolio was the main driver of this return – the bond portfolio was up 10.89% for the month. In addition, we had strong returns in our international equity portfolio (up 8.22%) and our domestic equity portfolio (up 2.23%). Both portfolios outperformed their respective market benchmarks for the month by wide margins.

Total Pension Funds

- For the month of December, the fund was up +6.31% versus +5.00% for the benchmark. (Note: the benchmark calculated for December is based on the former asset allocation plan adopted by the State Investment Council in December 2007. The benchmark for January 2008 will be adjusted to reflect the Council's new asset allocation plan adopted at the December 2008 Council meeting). Estimated performance for the pension funds for the fiscal year-to-date period through December 31, 2008 is -17.47% versus -20.11% for the Council benchmark. Our outperformance for the fiscal year is attributable to (1) our overweight position in domestic and international fixed income relative to public equities, and (2) our underweight position in commodities relative to the benchmark. Total pension fund assets as of December 31, 2008 were \$63.9 billion.
- We were net buyers of \$30.0 million of U.S. equities in December, with the major activity representing purchases of \$150 million in small/mid cap ETFs and \$125 million in convertible bonds and preferred stock, offset by sales of stocks in the financial and technology sectors. There was little activity in the international equity portfolio, with net purchases of only \$4 million. The major activity in the fund again was in the domestic fixed income portfolio, where we were net buyers of \$198.2 million. Finally, we funded an additional \$157.9 million in commitments to various alternative investments in December.

Domestic Equity

- Performance for Common Pension Fund A for December was +2.23% versus +1.52% 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 -28.16% versus -28.81% for the benchmark. The major positive factors contributing to overall performance continues to be our underexposure to the financial services sector and our program to purchase investment grade fixed income securities at attractive yields in lieu of the underlying equity securities. The major negative factor impacting performance is our exposure to the wireless tower stocks, which have underperformed other telecommunications stocks significantly in recent months.
- As stated above, net purchases of equities in the portfolio in December were \$30.0 million. The major purchases during the month were \$150 million in ETFs tracking the U.S. small cap and mid cap indices, and \$125 million of convertible bonds and preferred stock at attractive valuations relative to the underlying common stocks. (Note: in most cases, we swapped out of the underlying common stock into the convertible bonds/preferreds). The major sales were in the financial services and technology sectors. Names that were sold include Prudential, Union Pacific, ConocoPhillips, Wells Fargo, Merrill Lynch, and General Electric.
- We purchased an additional \$25.6 million in long-term corporate bonds within the domestic equity portfolio at attractive yields. Our strategy is to obtain equity-like returns on certain bonds in lieu of owning the underlying stocks. Bonds that were purchased include Alcoa, Cameron Corp. and Sprint.

Domestic Fixed Income

- Performance for Common Pension Fund B for December was +10.89% versus +11.23% for the Barclays Long Government/Credit Index, the benchmark for the domestic fixed income portfolio. Please note that the B Fund performance number includes the performance of our \$3.5 billion TIPs portfolio, while TIPs are not included in the Barclays Index. For the fiscal year-to-date period, Common Pension Fund B returned +4.83% versus +9.22% for the benchmark. The duration of Common Pension Fund B (excluding TIPs) was 10.15 years as of December 31, 2008, versus 11.49 years for the Barclays Long U.S. Government/Credit Index.
- We had net purchases of approximately \$198.2 million in domestic fixed income securities in December, consisting of \$272.3 million in net corporate bond purchases partially offset by sales of \$74.1 million of GNMA mortgage-backed securities. As noted over the past several months, we see strong relative value in long-term investment grade corporates at current yield levels. Major names that were added to the corporate bond portfolio were British Telecom, Cameron Corp., DuPont, Northrop Grumman, Procter and Gamble, Transocean and Weatherford.

International Equity/Fixed Income

- The equity portion of Common Pension Fund D returned +8.22% in December versus a return of +6.19% for the MSCI EAFE Index ex-Prohibited, the benchmark for the international portfolio, which is calculated by the Division and excludes those names deemed ineligible for investment under the State's Sudan and Iran Divestment Laws. For the fiscal year, the portfolio was down -34.89% versus -36.36% for the benchmark. Our portfolio of international sovereign bonds returned +10.03% for the month and +17.98% for the fiscal year-to-date period.
- We were net buyers of \$4.0 million in international developed markets equities in December. The major purchases were AstraZeneca (\$40.1 million), Reed Elsevier (\$26.8 million), BP (\$20.8 million) and Anheuser-Busch Inbev (\$18.1 million), offset by sales of Group Danone (\$28.8 million), Pearson (\$19.1 million) Christian Dior (\$16.4 million) and Partners Group (\$15.7 million).
- We eliminated our \$217.5 million of holdings in short-term JGBs in December. These funds were transferred into short-term Euro-denominated securities.

Alternatives

- During November we funded \$157.9 million of commitments to alternative investments.
- Please note that the portfolio values shown on Exhibits 1 and 1a for private equity and real estate reflect the most recent valuations made available to the Division. In most cases, the values incorporated in our report reflect reported values as of September 30, 2008 (Note: Hedge fund market values are current). We expect the reported market values as of December 31, 2008, which will likely be made available to us in March-April 2009, will reflect some further declines in market values.

Cash Management Fund

- Total assets in the Cash Management Fund were \$12.5 billion as of December 31, 2008. The current yield is 1.42% for state participants, and 1.32% for "non-State" participants.
- The percentage of the portfolio invested in US T-bills/Notes, U.S. Agencies and Canadian government securities is now 83.6%, which is the highest percentage in many years. This increase is driven by our credit concerns of various issuers of other types of money market instruments; we have both eliminated names eligible for purchase and reduced our credit limits on other issuers.