

Your VESTED



INTEREST

North Dakota State Investment Board

July 1999



THE EDUCATION OF A BOARD MEMBER



KNOWLEDGE ITSELF IS POWER.

— FRANCIS BACON, OF HERESIES —

Okay, so you want to bake a cake. Long before the icing goes on, the preparation begins. Chances are, someone you know and love taught you the first things you learned about baking. Notice the words, taught and learned. Solid clues to identifying the activity that took place... education. Education is fundamental. It is a process that takes on many forms and continues throughout our lifetimes. Whether in a formal setting or in our casual experience, we are learning and teaching almost all of the time. And we put our collective knowledge in action every day, even when we bake a cake!

All this talk of baking cakes fuels the appetite, so how about some food for thought? Imagine having the responsibility of making decisions that guide an investment program with assets in excess of \$3 billion. You would not take that kind of mission lightly, would you? You would contribute all of your knowledge and experience and invest in yourself as well. Always learning, always gaining knowledge; such is the way of the members of the State Investment Board (SIB).

Investment seminars and conferences provide an opportunity for learning and relationship building. Our SIB members carefully choose educational forums that will better equip them to meet the challenges of their roles. As one might imagine, trustees from other state investment boards also

attend these functions and have much to offer in terms of relevant experience and typically enjoy sharing the benefit of their knowledge and experience.

While conferences and seminars are occasional events, the SIB maintains a rigorous educational schedule right here at home. Every monthly meeting of the SIB begins with an educational segment. And sometimes we have two! A typical education session lasts an hour and is presented by an investment industry expert. Sometimes the topic relates directly to business that is on the agenda for later discussion, while other times it is of a more general nature and targeted to provide additional background knowledge. Topics studied by the SIB in the recent past include fixed income concepts, convertible securities, investing in Europe, reading investment performance reports, real estate and behavioral finance. This year, the Board will grapple with such subjects as tactical asset allocation, emerging markets, the anatomy of a private equity deal, small cap stocks, the credit markets and the economic outlook for Japan. Wow! That's some serious stuff!

They may not be ready to bake wedding cakes yet, but rest assured that State Investment Board members are continuously equipping themselves with knowledge to guide them through the investment jungle.



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FROM THE DIRECTOR'S CHAIR

CURTAIN CALLS



Steve Cochran, CFA
Executive Director/CIO

We have all gotten a phone call that we wish had never come. "Boy, everything was fine a few minutes ago until the phone rang." The recipient of bad news is not to be envied; being the messenger is no joy either. Each of us has some aspect of our job that is just no fun. For me, one of those chores is making the call to notify an investment manager of their termination.

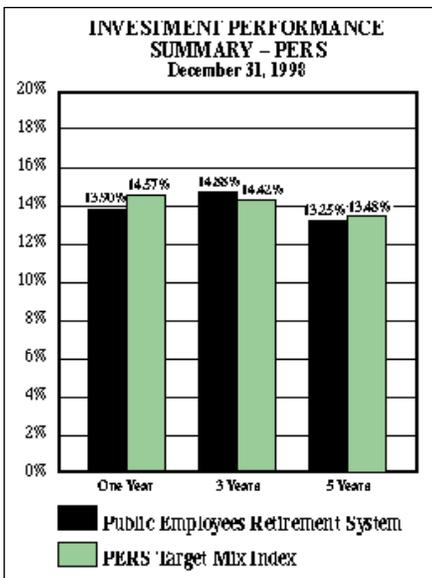
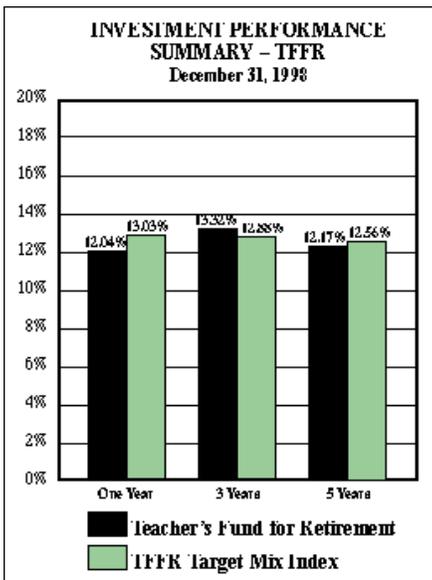
to build their relationship with their client, the State Investment Board (SIB). Because of the high level of coordination required to maintain an institutional investment program such as ours and the multi-year nature of the professional affiliations, we get to know these relationship managers pretty well.

Friendship and professional camaraderie aside, the economics of the equation are substantial. An investment manager employed by the SIB may manage upwards of \$100,000,000. That's a lot of zeros, folks, and responsibility that large does not come cheap. When terminated, a manager may be looking at saying goodbye to as much as \$500,000 in annual revenues. Ouch! Of course, I like to believe that it's the personal aspects of the termination that hurt the most, but pain hurts regardless.

Terminations rarely come as a big surprise and managers generally take the news standing up. So, when a money manager's phone rings on a Friday afternoon following an SIB meeting, the old adage takes on real meaning... no news is good news!

A typical investment management firm is organized along functional lines. Certain people are responsible for the day-to-day investment decision making. They're called portfolio managers. Most of us in this business agree that it's best to leave these people alone and let them do what they are supposed to do best - make investments.

For this reason, we have another breed of professionals populating the investment management firms - relationship managers. These affable people-oriented sorts are generally knowledgeable and experienced and quite able to assist the client in most matters. They come to Bismarck to report on the investment results of their firm and



INVESTMENT PERFORMANCE

Investment returns have remained robust for the one, three and five-year periods ended December 31, 1998. Double-digit returns continue to build the funds' values in excess of actuarial expectations. As indicated in the Investment Performance Summary tables (left), TFFR and PERS returns have been highly reflective of their policy target mix composite indices. This indicates that the funds are achieving the investment results expected through their respective asset allocation strategies.

AND IN THE END... *"Things are always at their best in the beginning."*

PASCAL, *Lettres provinciales*

A provocative quote, but perhaps a bit extreme. Always is a powerful concept; omnipotent and ruthlessly comprehensive. We may each imagine an exception to Pascal's assertion, but does it apply to money management relationships? A definite sometimes!

The State Investment Board (SIB) oversees the investment of more than \$3 billion – all of it externally managed. To facilitate this management approach, the SIB maintains contractual relationships with eighteen investment management companies. Some of these firms carry out multiple 'mandates,' or investment missions, for the Board. A typical relationship is perpetual in nature, but subject to a 30-day cancellation clause. From time to time, the Board's right to cancel must be invoked.

Terminating a relationship with an investment manager is serious business. Reaching such a definitive conclusion requires intense and thorough scrutiny. The very process of replacing one manager with another is quite expensive and should never be approached whimsically. Only after careful consideration does the SIB take such action.

As in our personal lives, money management relationships can end rather abruptly or slowly deteriorate, falling apart for a single identifiable reason or due to a veritable mosaic of uncertainties. Sometimes the termination of the relationship is not a falling apart at all, but rather an adjustment made due to structural changes in the SIB's investment strategy. In all but the most unusual of circumstances, the parting is amicable, based on rational cause, not emotional reactions.

Performance, or lack thereof, is a commonly cited reason for manager firings. When an investment manager is originally retained, there

is typically some expected return that the client and manager alike believe is feasible. The return objective may be absolute, such as 8 percent per year, or relative to some other measurable benchmark. A goal of outperforming the S&P 500 Index over any 5-year rolling period is an example of a relative return expectation. When the manager fails to meet or exceed a realistic investment return assumption, questions arise as to the manager's ability to perform.

While performance is often the motivating factor in a manager termination, many other circumstances may lead to the conclusion of a relationship. For example, a manager may exhibit significant 'style drift,' a major concern of institutional investors. Style drift occurs when the demonstrated investment style of a manager varies from the stated philosophy or investment orientation for which the manager was originally hired. A dramatic example would be that of an investment firm hired to invest in domestic common stocks who was, in practice, buying stocks issued in other countries. In a case such as this, the manager would not be filling the role for which it was hired and therefore undermines the structural integrity of the investment program.

Investment management companies may occasionally suffer internal woes. Squabbling about company control issues, investment strategy, firm focus, or other matters may lead to personnel defections, low morale, and a shift in attention away from the investment management function. Such situations are undesirable and should be closely monitored.

While certain activities involving fraud or other legal or ethical irregularities may certainly result in termination, sometimes the corrosive circumstances are not specifically

and clearly identifiable. A long-standing relationship may deteriorate over time as the level of confidence in the manager slowly declines. While no single reason may qualify the firm for termination, a combination of negative experiences and impressions may ultimately result in such action.

The SIB approaches situations that could ultimately result in a manager termination very methodically. At the first sign of trouble, the situation is discussed by the Board, and if warranted, the manager is placed on 'Manager Review.' This designation results in intense scrutiny of the firm to determine the severity of the situation. The Investment Director will carry out the Board's wishes in an effort to gather information and gain maximum insight into the state of affairs. The SIB may also commission its consultant, Callan Associates, to engage in intensified analytical activities to ascertain the seriousness of the situation. The SIB is continuously updated on the investigation and may ultimately remove the manager from the Review list if warranted, or take alternative action. The SIB has also empowered the Investment Director to place a firm on Manager Review prior to Board action if the suddenness and severity of the situation so dictates.

Manager terminations are costly and unpleasant experiences. The SIB must carefully weigh the cost/benefit attributes of such action and determine the most prudent direction. In its collective wisdom, the Board is cautious not to make hasty decisions, yet seizes the moment when termination is in order. Plan participants and beneficiaries can rest assured that the SIB maintains constant vigilance in carrying out its fiduciary responsibilities, which sometimes include the termination of investment professionals.



Scott Engmann

ENGMANN ANNOUNCES RETIREMENT

After 36 years of public service in North Dakota, Scott Engmann retired on June 30, 1999. Scott was the Executive Director of RIO/TFFR since 1981 and periodically served as interim SIB Investment Director.

During his lengthy and distinguished career, Scott dedicated himself to the service of the citizens of North Dakota, participants of the TFFR retirement system, and clients of the State Investment Board. Under his guidance, assets of the trust funds have grown tremendously and have always been invested solely in the best interest of the beneficiaries.

Engmann's strong leadership ability and exemplary model of stewardship have served the SIB well over the years. We thank Scott for his service, and wish him well in his new career... retirement.

Congratulations, Scott... and thank you!

MANAGEMENT CHANGES

The State Investment Board (SIB) has selected Steve Cochrane to succeed Scott Engmann as RIO's Executive Director and CIO. Steve joined the RIO staff as Investment Director in 1997. In addition to assuming the Executive Director duties, he will continue to assist the SIB in implementing the pension and insurance trust investment programs.

Fay Kopp, currently RIO's Retirement Officer, will become Deputy Executive Director and Retirement Officer. Besides assisting the Executive Director, she will continue to work with the TFFR Board in administering the retirement program for teachers.

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