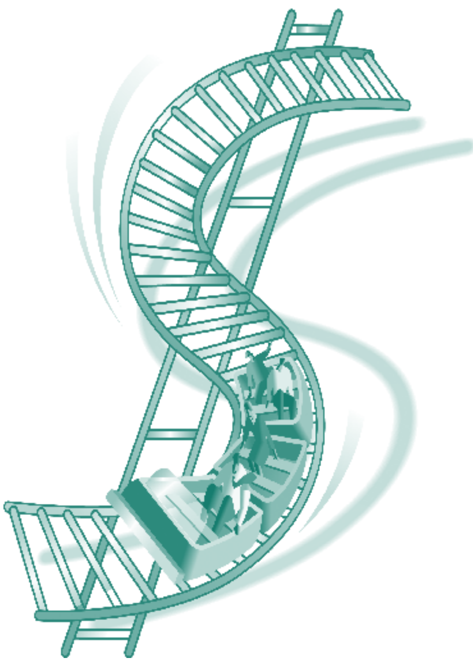
Your VESTED INTEREST

North Dakota State Investment Board April 2008

A BUMPY RIDE, BUT NOT A TAILSPIN



Since the beginning of this fiscal year, the economy has been a concern and the markets have reflected this state of uncertainty. Recently, Northern Trust Global Investments, one of the long-standing service providers to the State Investment Board (SIB), offered the following analysis of today's investment environment. Written in March, 2008 by Orie L. Dudley, Jr., Chief Investment Officer, it clearly states the firm's take on what is happening today.

THE WORD "RECESSION" STRIKES fear into the hearts of most investors, and investors have been hearing the R-word a great deal lately. And the U.S. equities market is likely going to face at least another three months of extreme volatility as the economy flirts with a recession and starts to mend.

Even though the volatility surely will make many investors edgy, the economic fallout won't be harsh, or last as long, as many fear. In fact, this stage in the business cycle could be viewed as an investment opportunity rather than impending Armageddon.

The global economic situation leading up to this recession — if this proves to be a recession — is very different from those leading up to previous recessionary periods in the United States. Before this downturn, the world economy was in the fifth year of a strong business cycle. It was, in fact, witness to the best global output period since the early 1970s. It was marked by significant, above-trend growth driven by global liquidity and accompanied by very strong savings rates in developing markets, which were the primary growth-drivers.

The Triple Shock: Housing, Credit, Oil

Now, admittedly, the U.S. economy has suffered some shocks. Key among them were the housing and mortgage market crises — both critical components in determining when the economy hits a nadir on which it can begin to rebuild — and oil prices.

Housing currently is in the worst cycle since World War II. The United States normally experiences a 32-month housing cycle, and it's currently in year three. The cycle is nearing the bottom, but not quite there yet. The problem is the huge inventory of homes for sale. Thus, housing starts will need to continue declining and sales will need to begin increasing before the housing sector truly bottoms out. We think the cycle will hit bottom and the numbers start to turn positive again during the second half of this year.

Hand-in-hand with the housing market problems is the credit market, which was torpedoed by well-publicized subprime credit problems that first surfaced over a year ago, and led investors to become increasingly suspicious about all asset-backed securities. In August, yields for asset-backed commercial paper in short-term money markets started to climb, sparking a safe-haven flight to buy U.S. Treasuries. Now money markets generally are viewed as bastions of stability, so these events proved particularly jarring to the entire financial system.

The "freezing up" of markets that is publicized in the press really did occur

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ND Retirement and Investment Office
1930 Burnt Boat Drive, P.O. Box 7100
Bismarck, ND 58507-7100
701-328-9885, Toll free: 1-800-952-2970
www.nd.gov/rio

FROM THE DIRECTOR'S CHAIR

Steve Cochrane, CFA
Executive Director/CIO

In preparation for this installment of "From the Director's Chair," I took a look at last spring's edition. As you may recall, our TFFR and PERS investment returns were on top of the charts, having experienced a very positive year ended December 31, 2006. I stated in the aforementioned newsletter that, "…it is important to maintain perspective. We don't always expect to be on top, nor should we." This statement truly sets the stage for this time period. The story is in the charts.

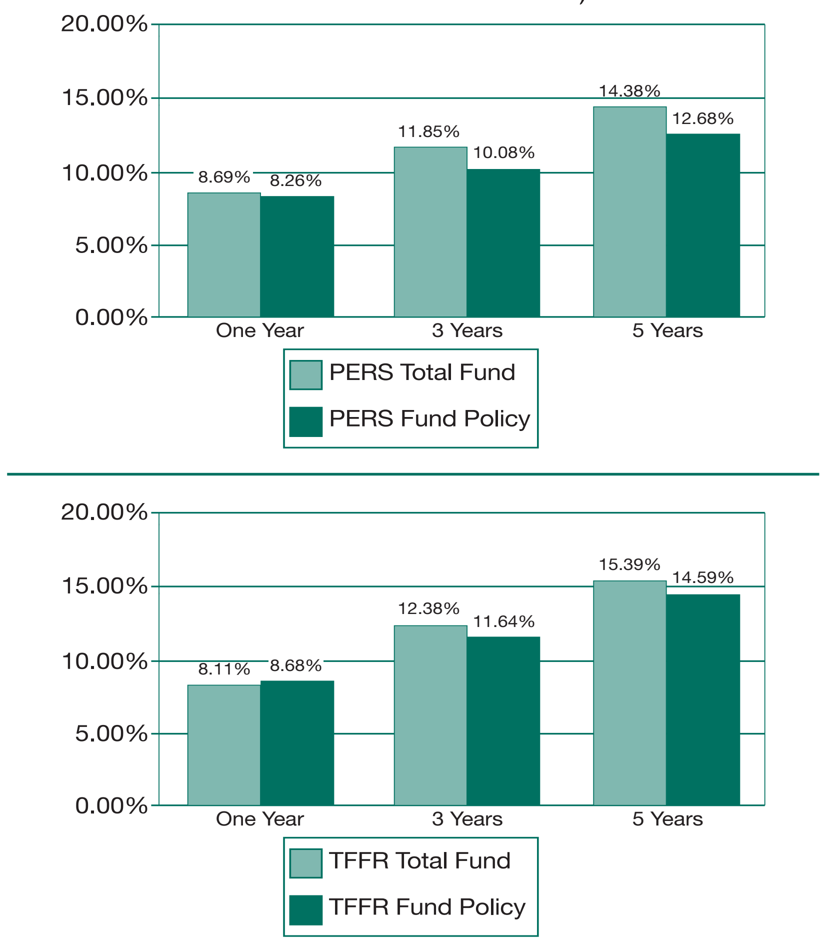
The bar charts for PERS and TFFR show the 1, 3, and 5 year net investment returns as compared to their respective benchmarks for time periods ended December 31, 2007. As you can see, the results vary between the two funds. PERS has outperformed its benchmark over all three time frames, while TFFR has lagged during the 1-year period. This is attributed to the difference in asset allocation between the funds. TFFR has more exposure to asset classes such as stocks, which were more performance challenged during this measurement period. However, the difference in performance between the two funds, for calendar year 2007, amounts to only 0.58%. It is also interesting to study the underlying numbers in the table for the same time periods. You will notice that TFFR's investment return has exceeded that of PERS for the 3 and 5 year terms. Why? Well, the markets, while very challenging, have been generally good over those years, and the more aggressive asset allocation of TFFR allowed it to capture a bit more upside. While over the long term, stocks tend to return more to the investor than bonds, there are "payback" periods, and we are in one.

There is some comfort in knowing that we are not in this alone. In fact, most institutional investors are experiencing similar situations. For a relative gauge of performance, we compare ourselves to the universe of public pension funds as measured by our investment consultant, Callan Associates. Shown on page 3 in floating bar chart format, is the relative performance for the PERS, TFFR, and the Pension Trust (the commingled investment vehicle discussed in previous issues). The charts represent the 1 and 5 year periods ended December 31, 2007. As you can see, these pools remain in the top half of the pool of similar funds for the 1-year period, and on a 5-year basis, show top decile investment return experience. Because we design our portfolios for long term performance, it is not unusual to see any short time frames lag or even compare unfavorably to the fund universe. In fact, it would not be surprising to find in June, that this fiscal year's performance is lagging due to the extreme, yet ultimately temporary, dislocation in securities market valuations.

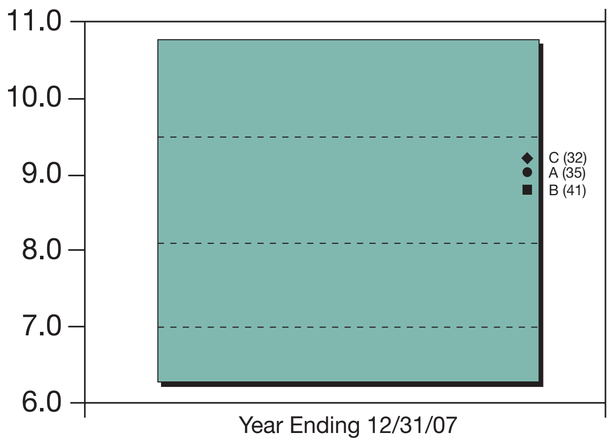
Alas, volatility is the nature of the beast, and this fiscal year has certainly been characterized by extreme price movements. Hang in there, as I have for 27 years now in the institutional markets, and we will once again have an opportunity to review our rewards.

NET INVESTMENT PERFORMANCE

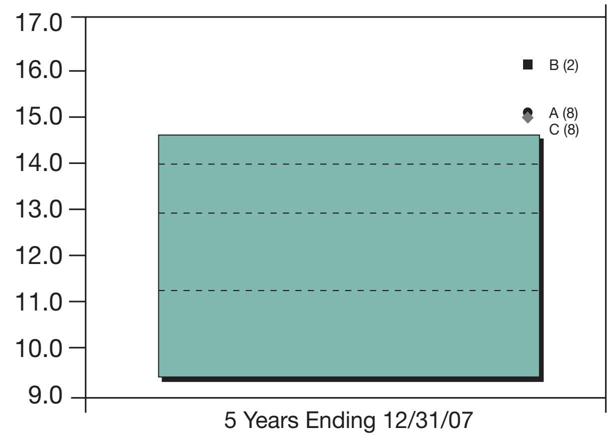
Periods Ended December 31, 2007



TOTAL FUND RANKINGS COMPARED TO CALLAN DATABASE



10th Percentile		10.58
25th Percentile		9.52
Median		8.30
75th Percentile		7.22
90th Percentile		6.46
Member Count		115
ND Pen - Total Fund	● A	9.01
TFFR Total Fund-Gross	■ B	8.79
PERS Total Fund-Gross	◆ C	9.20



10th Percentile		14.63
25th Percentile		13.92
Median		12.83
75th Percentile		11.56
90th Percentile		9.83
Member Count		109
ND Pen - Total Fund	● A	15.21
TFFR Total Fund-Gross	■ B	16.16
PERS Total Fund-Gross	◆ C	15.08

Target Asset Allocation

December 31, 2007

	TFFR	PERS
Domestic Large Cap Equity	28.0%	30.0%
Domestic Small Cap Equity	10.0%	10.0%
International Equity	18.0%	10.0%
Emerging Markets Equity	5.0%	5.0%
Alternative Investments	5.0%	5.0%
Domestic Fixed Income	12.0%	24.0%
High Yield Fixed Income	7.0%	5.0%
International Fixed Income	5.0%	5.0%
Real Estate	9.0%	5.0%
Cash Equivalents	1.0%	1.0%
TOTAL FUND	100.0%	100.0%

A Bumpy Ride

Continued from page 1

this time. No one wanted to step out and transact because of asset-backed securities suspicions. In response to the evolving crisis, the Federal Reserve lowered interest rates and injected liquidity by relaxing its discount window borrowing standards, in an effort to un-seize the market. But ultimately, the crisis rattled confidence in the markets and, some would venture, in the Fed itself. U.S. equities hit an all-time high in October, but started unraveling by year-end.

Since October, U.S. interest rates have fallen dramatically and likely will fall even further during the next few months to shore up the economy. The Fed, whose policy curve has fallen behind the market-based curve, likely will cut its Fed funds target rate by another 50 basis points in March 2008 and by another half-point soon thereafter to kick-start the economy.

The third shock that hit the U.S. economy in 2007 was the increase in oil prices. Crude oil broke $100 a barrel for the first time ever. But because the amount of oil needed to generate $1 of gross domestic product (GDP) has dropped, the oil price rally hasn't caused the same amount of damage as it might have in the past when it represented a larger portion of GDP.

Economic Wildcard: Consumer Spending

January's drop in nonfarm payroll numbers scared the Fed. Granted, these monthly figures are notoriously volatile and subject to sometimes-startling revisions, but the overall trend points to a decline in employment. Today's 4.9% jobless rate isn't near the rates typically seen during recessions. Even the possible 5.5% or 6% unemployment rate at the end of this year is lower than what is typical in a recession. But this rate still spooks the Fed because it affects consumer income, which drives spending.

The last decline in consumer spending was in 1991. So the U.S. economy has seen 64 consecutive quarters of growth in consumer spending. Even though liquidity and income have become less volatile during the last 35 years, if unemployment rises dramatically, it will hurt consumer income, thus affecting spending.

Balancing Stimulus With Inflation Concerns

The Fed's anticipated move to lower the Fed funds rate by another full percentage point in 2008 may help bolster the economy. But at the same time, concerns about recession must be balanced against concerns about inflation.

When you want to stimulate the economy, you ease monetary policy — as the Fed is doing aggressively now — implement fiscal stimulus — as the White House is doing with the tax rebate checks — and depreciate currency.

The most obvious risk of the U.S. dollar's lack of strength is that it will contribute to inflation. The dollar's deflated value increases the cost of foreign goods and services, which can contribute to a higher cost of living for consumers (inflation), which could lead to an increase in interest rates to quell inflation and protect the currency.

The Fed is focused on expectations. And one way to gauge the market's inflation expectations is to take the 10-year nominal Treasury note and subtract the Treasury Inflation-Protected Securities — this shows what the market is pricing in for the consumer price index during the next 10 years. So, even though the market expects that inflation will rise during the next 10 years, it's only pricing in a level of inflation of about 2.2% — which isn't that high. Because inflation expectations aren't high, the Fed feels it has a window of opportunity to let the currency erode, which would stimulate exports and

benefit multinational companies that have business outside the country.

Credit Access Has Not Dried Up

Fed policy doesn't directly affect consumers; it affects banks. Bank behavior, however, does affect consumers. People, including the all-important consumer, are worried about entering a true bear market because they think bank lending will dry up, taking access to credit with it.

Right now, the government lenders' survey shows that bankers are tightening lending standards. Yet, 90% of businesses say they aren't having problems with financing. The much-ballyhooed bank lending slowdown is evident only in surveys, not yet in actual numbers.

In the capital markets, the price of the 10-year bond, at 3.6% currently, is a stimulant. Even BBB-rated borrowers still can get money at 2.5% over 10-year bonds, which certainly isn't restrictive. But credit spreads are rising as concern about less creditworthy entities has grown. However, even the high-yield market isn't seeing a spread where it was in the early 1990s; nor have there been defaults in this market.

Is a Recession Inevitable?

Consumer net worth is based primarily on three pieces: housing prices, equity prices and bond prices. Housing prices

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THANK YOU HOWARD

Special thanks to Howard Sage for 18 years of dedicated service on the State Investment Board including 11 years as Vice Chair. We congratulate you on your retirement from state employment and wish you many happy and fulfilling retirement years.

A Bumpy Ride

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in the 20 largest metropolitan areas are down 10%, and equity prices appear to be headed lower. But with the equity markets near the bottom, housing prices will have to be watched to determine whether a bear market is coming.

Equity markets are nearing the bottom because entering this period corporations are in excellent condition. Profit margins as a percent of GDP are holding. Free cash flow is strong and has produced ongoing dividend increases. We expect dividends this year to grow about 10% despite slower economic growth because of operating strength.

Share repurchases continue to fly off the charts, and mergers and acquisitions are again starting to increase, driven by strategic acquisitions. This trend likely will continue unless there's a collapse in earnings.

Aggregate earnings in the fourth quarter were down 20%; yet after excluding financial companies, overall earnings were up 14%. So, outside of the financial industry, corporate performance and earnings are still high. There will be further write-offs in the financial sector, and estimates are probably still too high.

A normal recession would see corporate earnings decline 30%. In such a scenario, the Standard & Poor's 500 index could fall another 5% from where it stands today.

Sovereign Wealth Funds a Factor

Sovereign wealth funds have become large investors in the global markets. At an estimated $2.5 trillion, their size dwarfs even the combined $1.5 trillion invested in hedge funds and private equity. And they're often major players in capital markets.

For example, eight major U.S. and European banks that wrote off more than $100 billion of subprime-related assets were able to raise $85 billion in capital from sovereign wealth funds within three weeks. Sovereign wealth funds, led by China, have begun investing more intelligently and actively.

Follow the Funds, Not the Herd

Because the sovereign wealth funds aren't interested in short-term trading horizons of less than five years, they're not following the herd like many other investors. And neither should you. While I wouldn't advise anyone to run out and take a lot of risk tomorrow, you don't want to compromise your five-year plan by selling into this market.

Globalization is bolstering the economy, the Fed's policy response is stimulative and companies are in good shape going into this period. Even though the market will be much more volatile as it tries to build a base during the next several months, it also likely will overshoot. And that provides opportunity.

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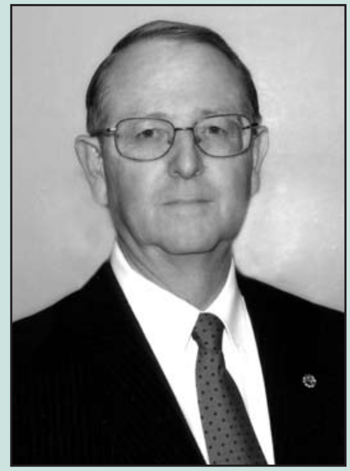

CORNEIL NAMED VICE CHAIR

The State Investment Board (SIB) recently elected Clarence Corneil to serve as Vice Chair. He replaces Howard Sage who retired December 31, 2007.

NEW SIB MEMBER

The SIB would like to welcome Adam Hamm to the board. Mr. Hamm is the State Insurance Commissioner and his current term in office ends December 31, 2008.

2007 ANNUAL FINANCIAL REPORT AVAILABLE

The North Dakota Retirement and Investment Office Comprehensive Annual Financial Report (CAFR) may be viewed from our website, *www.nd.gov/rio* or a copy may be requested by contacting the administrative office. This report is a complete review of the financial, investment, and actuarial conditions of the State Investment Board and the Teachers' Fund for Retirement.

NORTH DAKOTA
RETIREMENT AND
INVESTMENT OFFICE
Teachers' Fund for Retirement
State Investment Board
1930 BURNT BOAT DRIVE
P.O. BOX 7100
BISMARCK, ND 58507-7100

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