Your Vested Interest

North Dakota State Investment Board

October 2008

MARKET COMMENTARY

By William W. Priest, CEO
Epoch Investment Partners

Since the summer of 2007, the markets have been in turmoil. It is clear in retrospect, that much of the experience of the year was "in the cards." One of the few observers, who anticipated much of the last several years' developments, is William "Bill" Priest, CEO and Chief Investment Officer of Epoch Investment Partners. His ability to clearly see the economic and financial environments has prompted us to reprint his Market Commentary published August 26, 2008.

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

As informed investors, it is impossible to ignore the symptoms of the global economy's failing health reflecting the ongoing deleveraging of the global economy. Especially with the doubling of oil prices in the span of a single year, there is ample evidence that global demand will falter, global growth will be seriously threatened, and a U.S. recession will almost certainly be in the cards. But the point of this paper is not to simply rehash this grim diagnosis. Rather, it is to offer a perspective on both the nature of the illness and its potential cures, all of which can be found both at home and abroad.

The contagion in our midst had been spread and amplified by the reality of global trade. Nearly one third of the world's production of goods and services is now traded, with the U.S. consumer accounting for 72% of domestic GDP and the global consumer accounting for 60% of global GDP. The linking of our international economies via trade, therefore, will mean a worldwide slowdown will manifest itself most severely within the U.S. as the American consumer continues to feel the squeeze from the deleveraging process of a decline in housing prices, tighter lending standards,

and the effect of a doubling of energy prices on an already stretched budget. And with Trichet having led Europe into an illfated policy of tight money, the outlook is probably worse in Europe than many pundits want to acknowledge. The BRIC countries are fighting inflation internally and the policies of their central banks remain behind the curve, indicating the eventuality of interest rate increases. In China, as an example, wage growth rates are growing seven times faster than export growth rates.

One of the most obvious symptoms of this global economic malaise is the weakness in the U.S. financial sector which is closely linked to the bursting of the housing bubble. Although the fallout of this financial crisis is ongoing, it is now possible to get a clearer view of its potential dimensions, which are specified in the spread between $500 billion already written off to the $1.6

Continued on page 4

FROM THE DIRECTOR'S CHAIR

Steve Cochrane, CFA
Executive Director/CIO

The way the markets have gone this past fiscal year, I considered renaming this piece, "From *Under* the Director's Chair!" As we move into the 2009 fiscal year, the markets are still finding themselves very nervous and prone to rapid pricing adjustments.

We can think of the "markets" with their stock market averages and bond market yields, as the *financial economy*. This is different than the real economy, the one we live in everyday and exhibits such health indicators as inflation rates and unemployment statistics. They are, of course, related in the long run, and in a sense the real economy serves as the environmental backdrop for financial market activity. As for backdrops, this past year has not been very picturesque.

Fiscal year 2008 presented a very negative real economy. Whether we review the dramatic increases in unemployment, home foreclosures, inflation or energy prices, the conclusion is very painful. Reflecting on the declines in US Gross Domestic Product (GDP), manufacturing activity, and consumer confidence, leads us to the same feeling of economic queasiness.

As the 2008 fiscal year began in July of 2007, the financial markets began to reflect the disintegrating characteristics of the real economy. As the realities of the problems within the mortgage markets began to come to light, the investment world began to seek shelter. Investment holdings which were considered to contain an element of risk (all investors know that risk and return go hand in hand!) were dumped in favor of US Treasury securities. Stock related to the financial sector and consumer spending were hit hard. Because the consumer is such a vital part of the US and global economies, expectations of slowing economic activity drove market prices down even more. All in all, this past fiscal year was very difficult for investors, and the current fiscal year has also been challenging thus far.

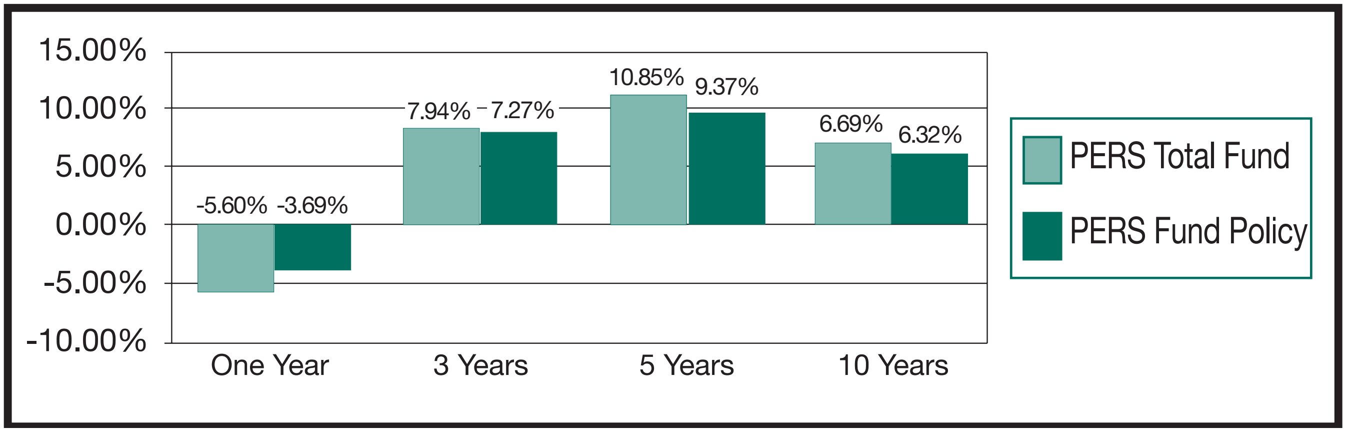
As seen on the page 3 charts, PERS and TFFR were in negative territory for the year. It is fortunate that we have seen several strong markets since 2003 with the result being that the 3-year and 5-year returns are solidly positive. However, when we extend the view to 10-year returns, average annual returns fall below 7%. This is the result of having four negative/low return market years in the last ten. The process of "paying" for poor market periods is slow and painful. It takes a great deal of time to recover negatively-affected annualized returns in multi-year measurement periods. For reasons associated with this, defined benefit plans are not structured to increase benefits quickly when markets improve. It takes years to regain lost funding status.

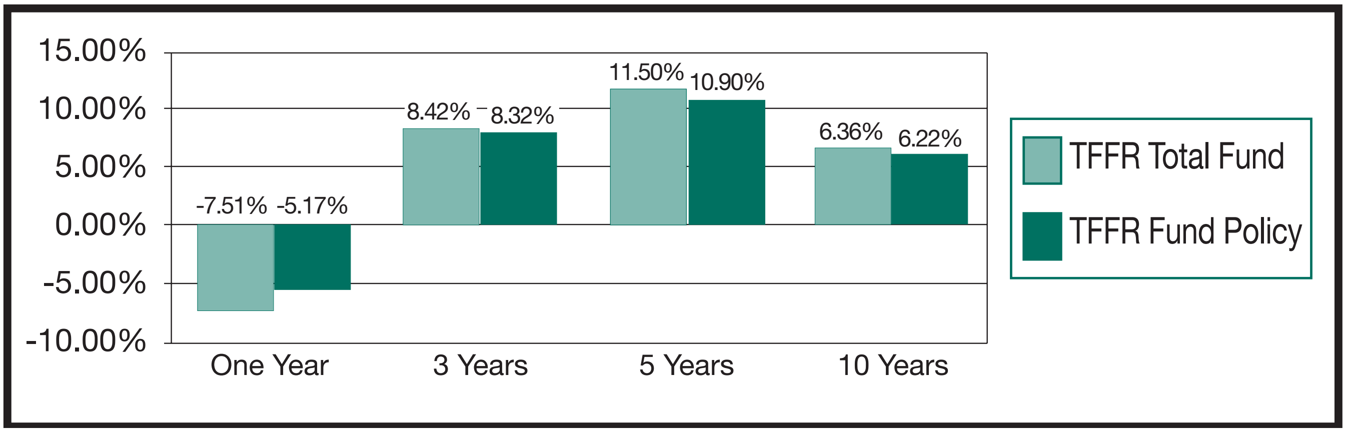
From time to time, we discuss asset allocation in this column. It is worthy to note that while the globalization of markets has certainly created a more integrated world economically, it has also moderated the impact of traditional diversification. In the 1980's and 1990's, the ability for funds such as ours to hold securities of other developed world countries, served us well in distributing risk and return opportunities. While diversification is still of extreme importance, it is more difficult to obtain given the close ties that have developed between various countries' economies. The State Investment Board has worked for years to improve our ability to diversify in this increasingly homogenous world. That said, asset allocation still has a measurable impact as illustrated by the fact that PERS and TFFR continue to vary in performance over time periods, a fact that is reflective of their somewhat different allocations.

In summary, these are trying times for the world's economic and financial systems. We will do our best to guide the plans through this challenging environment and we look forward to the day when we see bluer skies to greet us.

NET INVESTMENT PERFORMANCE

Periods Ended June 30, 2008





Target Asset Allocation

June 30, 2008

	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%**

Market Commentary

Continued from page 1

trillion estimated by Bridgewater Associates. (Nouriel Roubini, the NYU Professor recently profiled in Barron's has a $2 trillion number.) If one wanted to hazard a guess at the real-time spread, one could say that it is now between $900 billion and $1 trillion (about the same estimate recently made by the IMF): an indication that we are about half way through this storm. The storm will not abate, however, until housing prices hit bottom, which is still a year away. However, there are signposts that can be used to forecast the storm's end: purchase mortgage applications, mortgage rates, home sales, home inventories, and home affordability measures. So long as employment does not decline sharply (which is a big "if"), one can envision better conditions by late 2009.

To observe the beginning of the end of the ailments outlined above, we must start with the dollar. The "trade" of going "long" commodities and "short" the dollar is ending. In this instance, oil is the lynchpin, which should fall below $100/barrel. The dollar will rally on that basis alone. Global demand destruction has been severe from the combination of the surge in energy prices and the tightening of credit as bank balance sheets have witnessed a contraction of equity. As a result, this "trade" will come under severe pressure in our view.

At the same time, U.S. companies continue to be on sale for investors who can pay in the Canadian Dollar, the Pound, or the Euro. Granted, there are many ways to look at relative currency values; but, from the standpoint of purchasing power parity, the Euro could fall a quarter and the pound even further from their recent highs. This could signal the onset of real overseas interest in U.S. assets. Foreign investors will not start investing in the U.S. until they see the dollar start to rise and their own currencies heading lower.

As for the bond market, foreign investors know that, based on historical precedent, buying U.S. bonds at a yield below inflation makes no sense. Conversely, an investment in equities will ultimately protect the investor from inflation and allow the investor to participate in the benefits of productivity from both capital and labor. In our view, foreign savings will find their way into high-quality global equity companies – many of which are domiciled in the U.S. – either directly (through acquisition) or indirectly (through the capital markets). Our guess is that one will see lots of cross border investing by non U.S. companies, particularly after the election. Hopefully, once the new administration is in place, Congress will be less likely to react to deals with the equivalent response of capital controls, thus tripping the wire for a global depression and a new version of Smoot Hawley. On a positive note, it is a good sign that InBev was permitted to buy Anheuser-Busch. This provided the important signal that capital can move globally. "Buy America" will become a theme.

In many respects, the world economy seems to be in its most trying state since the 1930's. But it is nowhere near as serious today as it was back then. When Roosevelt took office in 1933, one quarter of working age males were unemployed. Banks, on the brink of failure, were closed in order to enact legislation to protect depositors. Today, we are nowhere near that state of crisis. Other than a few radicals in the Middle East, no sovereign nation has a vested interest in seeing our capitalistic "system" fail. That was not true in the 1930's, when many "isms" competed for attention, power, and supremacy over the allocation of economic resources.

In conclusion, here are some general points to keep in mind:

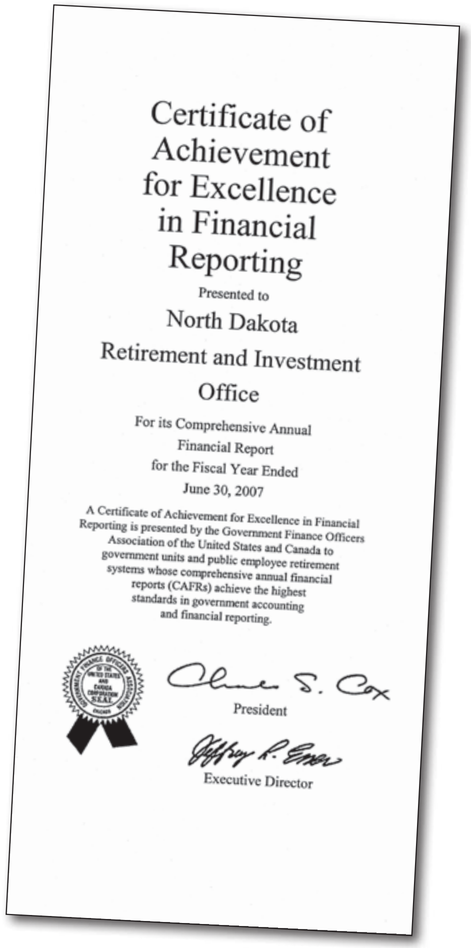
1. The world generates about $7 trillion a year in savings. This sum will get invested one way or another, sooner or later.
2. Globalization, through the application of the Law of Comparative Advantage, has been good for every nation in the broad sense that living standards have risen, capital productivity has risen, and inflation has been less than it otherwise would have been given the growth rate of global GDP over the past 20 years.
3. At present, deflation is a bigger threat than inflation reflecting the consequences of the deleveraging process now going on.
4. Until inflation gets into the wage system, it is not a problem.
5. The global financial system is threatened, but the dimensions of the problem are beginning to be quantified, regulators are starting to regulate, and a glimmer of hope is beginning to emerge.

Continued on page 5

ACHIEVEMENT AWARD RECEIVED

The ND Retirement and Investment Office (RIO) is pleased to announce that its Comprehensive Annual Financial Report (CAFR) for June 30, 2007 has qualified for a Certificate of Achievement for Excellence in Financial Reporting from the Government Finance Officers Association (GFOA).

The Certificate of Achievement is the highest form of recognition in public employee retirement system accounting and financial reporting, and its attainment represents a significant accomplishment. This report must satisfy both generally accepted accounting principles and applicable legal requirements.


Certificate of Achievement for Excellence in Financial Reporting

Presented to

North Dakota Retirement and Investment Office

For its Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 2007

A Certificate of Achievement for Excellence in Financial Reporting is presented by the Government Finance Officers Association of the United States and Canada to government units and public employee retirement systems whose comprehensive annual financial reports (CAFRs) achieve the highest standards in government accounting and financial reporting.

President

Executive Director

Market Commentary

Continued from page 4

6. The dollar will appreciate, if for no other reason than other currencies must fall. Trichet will have to relent and loosen interest rates late in 2008, commodity currencies will fall (the A$ and the C$) and the U.S. dollar will, therefore, effectively rise.
7. The theme of "Buy America," both literally and figuratively, may well begin after the election. The present political regime will be over, and regardless of which party wins, there will be a perception of a long-awaited new dawn in U.S. politics.

As a final caveat, it should be noted that there are two potential impediments to the realization of the scenario detailed above: 1) if the real economy proves to be worse than imagined and employment in the U.S. declines abruptly, and/or 2) if Congress places capital controls on cross border deals. But if we manage to sidestep these dangers, the U.S. economy – and, for that matter, the global one – should regain its health and emerge even stronger and more stable than before.

Reprinted with permission by Epoch Investment Partners.

NEW SIB MEMBER

The SIB would like to welcome Levi Erdmann to the board. Mr. Erdmann is the IT Director for the State Land Department and represents PERS on the SIB.

SIB OFFICERS ELECTED

The State Investment Board (SIB) recently held its annual election of officers. The SIB chose the following members to hold leadership positions for the 2008-2009 fiscal year:

Lt. Governor Jack Dalrymple
Chairman

Clarence Corneil
Vice Chair & Parliamentarian

SIB AUDIT COMMITTEE

The Audit Committee is the only standing committee of the SIB. This committee is authorized to develop and direct the internal audit program for the Retirement and Investment Office (RIO), as well as oversee the annual external audit function. RIO employs a Supervisor of Internal Audit and one internal auditor.

The Audit Committee meets regularly to conduct essential business and contributes to the overall sense of fiscal security that RIO strives to maintain in its role as administrator of the State Investment Board and Teachers' Fund for Retirement programs.

The SIB Audit Committee consists of five members – three from the SIB and two independent participants. Current members include Mike Gessner, representing the Teachers' Fund for Retirement; Ron Leingang, representing the Public Employees Retirement System; and Cindy Ternes, designee of the Executive Director of Workforce Safety & Insurance, representing elected and appointed officials. Lonny Mertz, CPA, CIA, CFE employed by the ND Department of Health and Rebecca Dorwart, CPA, CIA with MDU Resources Group, Inc. serve as independent participants on the Committee.

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