YOUR VESTED INTEREST

North Dakota State Investment Board — March 2010

FROM THE DIRECTOR'S CHAIR

"And I sincerely believe, with you, that banking establishments are more dangerous than standing armies; and that the principle of spending money to be paid by posterity, under the name of funding, is but swindling futurity on a large scale."

Thomas Jefferson, 3rd president of US (1743-1826). Closing sentence in his May 28, 1816, letter to John Taylor. Source: Snopes.com

Steve Cochrane, CFA
Executive Director/CIO

Is the Credit Crisis Over?

I think most Americans wonder more if the credit CARD crisis is over.

In my day-to-day travels here in Bismarck and in talking to friends in high unemployment states like California and Florida, I ask folks I encounter how their business is going. Are they seeing more or less sales and customer traffic? What's the job market like in your area? Do restaurants and malls look busy or empty? It's my unscientific way of keeping a finger on our economic pulse.

As part of my somewhat nosy pursuit, I also ask about peoples' experiences with credit cards. My wife, who masterfully manages our personal finances, has been sharing insights for a long time on adjustments being made to our accounts by credit card issuers, none of which seem to be favorable or reflective of our credit history. I listened and stored her information away in my "U.S. economic deterioration" mental folder, doing little more than encourage and applaud her efforts to continue to stay on top of the situation and make the best of it. But at the same time, I was on a personal mission to see if we were the only ones this seemed to be happening to. Turns out, we are in good company.

Here are some credit card practices we've experienced personally or heard about from others. I think it's important to point out that I am not talking about a bunch of deadbeats here, but rather, good, productive, honest, hard-working Americans who pay their bills.

Card providers have:

- Suddenly shortened the payment cycle.
- Reduced the available credit balance, often dramatically, without appropriate prior notification, often resulting in one- or two- month lags before the customer realizes what is happening to their account.
- Changed the grace period policy to "no grace period."
- Increased over-the-limit and late fee charges.
- Increased the card's interest rate, often by multiples of the original rate.
- Increased the required minimum payment.
- Sent bills that arrive with little time before the payment due date.
- Made it harder to reach a live representative for help.
- Eliminated any flexibility such as waiving annual fees for loyal card holders.
- Encouraged card users to access their accounts online, then used those

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Is the Credit Crisis Over?

– Response from JPMorgan Chase

Lenders, Borrowers Face Challenges
Despite signs of economic recovery and an improved credit environment, the banking industry continues to face a number of challenges. Heightened regulatory oversight has had a significant impact on overall number of loans extended and the number of borrowers that qualify. In addition, the banking industry is facing weak loan demand and rising loan losses. Although today's banks provide less than 30% of traditional lending, these factors are contributing to a reduction in the pool of available credit banks have to lend businesses and consumers.

Public disenchantment with banks has focused on their perceived largesse from government bail out funds and the impression that they are proactive proponents of cutting consumer lending services. In reality, banks face a number of pressures from external sources. The purpose of this article is to highlight some of the issues that are constraining banks and contributing to tighter lending terms and reduced credit availability in the current environment.

Increased Regulatory Oversight
Regulators – while well-meaning – have contributed to the erosion of available credit by enforcing more stringent lending rules for both borrowers and lenders. For many of these borrowers, credit terms have changed drastically as new restrictions on banks have been passed on to their customers. The result has been a decline in the overall number of loans made to new borrowers, reduction of established credit lines, and in some cases, pressure on existing borrowers to provide additional funds or collateral. For borrowers facing unexpected capital calls, these restrictions may further damage the borrower's financial standing by resulting in forced asset sales that can destroy value.

While this represents the extreme case, far more common is the toll this new credit environment has had on the average individual. Credit, which has long been used to supplement income and fund purchases, has become harder to obtain and consumers, used to using credit for everything from auto loans and education to consumer goods and vacation travel, are feeling the pinch. For those that have felt the squeeze of credit tightening, it is easy to imagine that banks hold all of the cards, however, the economic downturn in combination with a much stricter regulatory environment has hit the banking industry hard.

Weak Loan Demand
Declining loan demand is having a negative impact on bank earnings and lending capacity. Loan demand has waned as businesses have reigned in capital expenditures, investments in R&D, and credit line utilization in response to the economic downturn. According to NFIB, (The National Federation of Independent Business), "Overall, loan demand remains weak due to widespread postponement of investment in inventories and record low plans for capital spending."

Similarly, consumers have also cut back spending. Those who are able are saving more and using those funds to repay debts. Lower loan volumes from both businesses and consumers have resulted in declining earnings from lending activity and reduced the amount banks have available to lend.

Rising Loan Losses
Banks are also feeling the pinch from rising loan losses from distressed borrowers. The drop off in demand for products and services across many sectors of the economy has hit businesses hard, cutting deeply into sales and earnings and reducing their ability to remain current on their obligations. At the same time, rising unemployment has contributed to declining income levels for consumers. Like weaker loan demand from creditworthy borrowers, delinquencies and write-offs from troubled borrowers, whether commercial or consumer, have also eaten into banks' profitability and lending pools.

Less Credit Available
The confluence of these factors has contributed to declining profitability for banks which means they have less money available to finance lending. At the same time, the collapse of the secondary markets which make up more than 70% of lending for mortgages and consumer credit products means that an important source of credit which was provided by "non-banks" has dried up.

- In reality, many of the stories about the lack of credit are due to the weakness of non-bank lenders and the weakness of the securitization markets.

The end result is that credit that is tapped through business and personal loans, home and auto loans, and credit card lines is now tighter for everybody from creditworthy borrowers that have a history of responsible credit usage to those with more marginal credit. Though credit lines have been reduced for some borrowers, the news is not all grim:

- Credit card utilization rates for individuals have risen somewhat but still remains relatively low at 18.7%. Rates for businesses are 5–10% below normal, as recently noted by Goldman Sachs at its U.S. Financial Services Conference.
- In addition, there is approximately $6 trillion in unused commitments that are available from FDIC-insured banks.

These levels indicate that there is a considerable amount of credit available in the system overall. As the economy continues to recover, it's likely that more of it will be put to productive use as more businesses and individuals gain access to it.

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Source: American Bankers Association. Lenders and Borrowers are Exercising a Prudent Approach to Credit. Bank Lending Fact Sheet. ABA. Web. 4 Feb. 2010. www.aba.com.
i *NFIB Small Business Economic Trends*, November 2009. National Federation of Independent Business.
ii *United States: Financial Services. Key takeaways from the US Financial Services Conference. Goldman Sachs*, December 10, 2009.
iii Treasury Press Statement, December 9, 2009, TG-436. United States Department of the Treasury.

From the Director's Chair

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contacts for sales pitches for identity protection services and credit reports.

- Charged fees if card users don't spend enough on the card or don't use it at all for certain time periods.

I doubt that this is an exhaustive list, but I think you get the drift. This is enough to frustrate many of us, but what inspired this article was an event that occurred when I took my wife to a large regional retail store to finish some after-Christmas shopping. When we tried to buy about $800 in goods, we were told that our store-branded Visa credit card was being declined. What? This is a card which we did not seek, were encouraged to apply for with incentives by the store, and used as one would a credit card.

The store manager initiated a call to the bank that issued the card, who said they didn't think we used it enough and reduced our limit from $8,000 to $1,000. We ended up buying our goods with another credit card instead.

I think if I were the store manager, I would be upset. After all, a customer's incentive to purchase goods from the store is apparently being dramatically reduced by the bank that services their store's credit cards. And somehow, I thought all this "stimulus" from Washington was supposed to help the consumer and the retail sector, which used to account for 2/3 of our economy, get back into gear.

I can't help but wonder why credit card firms charge such high interest rates while banks offer depositors incredibly low rates. These high interest rates and the dozens of new fees charged to customers are on top of the fees the card issuers charge retailers that accept their cards.

Could it be because, like they did for years with mortgages, they issued credit cards to anyone with a pulse and are now suffering losses due to mass bankruptcies? I can only wonder.

As this newsletter goes to print, news source Bloomberg reports that Alan Greenspan said in a speech to the Credit Union National Association's Governmental Affairs Conference in Washington that we just had "by far the greatest financial crisis globally ever." He also said small businesses show few signs of improving because lenders (banks) are struggling with commercial real estate mortgages.

But the news is not all bad. In fact, I just got a letter from a credit card issuer that was entitled, "Good News!" Now that the February 22 date has passed for government mandated reforms to take effect, they wanted to tell us about all of the nice new things they were doing for us!

In related late breaking news, Pensions and Investments reports Wall Street's annual bonuses rose 17% to an estimated $20.3 billion in 2009, according to a news release by New York State Comptroller Thomas P. DiNapoli, the sole trustee of the $129.4 billion New York State Common Retirement Fund, Albany.

In the news release issued Feb. 23, Mr. DiNapoli noted that "Wall Street is vital to New York's economy. But for most Americans, these huge bonuses are a bitter pill and hard to comprehend."

"There's a lot of resentment against the industry over its role in the global economic meltdown," Mr. DiNapoli said in the release. "Taxpayers bailed them out, and now they're back making money while many New York families are still struggling to make ends meet."

The State Investment Board has employed JPMorgan Chase as an investment manager for more than 20 years. We asked for their perspective and appreciate their willingness to respond. (See response on page 2.)

"Ask Again Later"

The Magic 8-Ball, invented in 1946 and manufactured by Mattel, is a toy used for fortune-telling or seeking advice. We all wish we had a reliable one. In the absence of such prescient guidance, we thought it might be interesting to ask an unscientifically-drawn sample of individuals of diverse backgrounds, this question:

Where will the United States be as a participant in the global economy in ten years?

Many thanks to those who responded. Here we go:

- We, the United States of America, need to be ready, willing, and able to change as the world changes. Our young people are full of new ideas, and though not all good, need to be recognized as leaders. The Bill Gates and Steven Jobs of the world are bringing about changes, and they are acting, in part, on ideas from our young entrepreneurs. *– Auditor*
- I think the U.S will continue to be a leader in the global economy over the next several years. However, it will certainly be a leader, rather than the leader. To be the leader, we will really need to shrink our deficit considerably and I don't see that occurring in the next decade. *– News Reporter*
- The balance of economic power in the world has already started to shift towards the faster-growing emerging economies, mainly located in Asia. The headwind of de-leveraging is largely a developed world problem which will impact governments, companies and individuals in the G7 for many years to come. It will be much harder for countries such as the USA to return to the high rates of economic growth that have been common over the past decade, and for this reason, the trend is likely to continue for some time. America, however, has the advantage of an entrepreneurial and flexible population who are willing to take risk and seize the opportunities which will arise, and this should limit the fall in the country's economic and geopolitical importance relative to other developed nations. *– UK Based Investment Manager*
- I don't have a clue. And I don't think the "experts" do either. (You know, the folks who failed to predict our current recession.) I can only hope things get better..... *– Retired Newspaper Editor*
- The true legacy of banking crises is greater public indebtedness, far beyond the direct headline costs of bailout packages. On average a country's outstanding debt nearly doubles within three years following the crisis. The aftermath of banking crises is associated with an average increase of seven percentage points in the unemployment rate, which remains elevated for five years. Once a country's public debt exceeds 90% of GDP, its economic growth rate slows by 1%. *– Quoted by Investment Manager from the popular book, This Time is Different*
- I would say that I won't be throwing out my Australian passport anytime soon! *– Marketing Executive*
- If the U.S. continues to be a participant in "free trade" and our "monetarist" financial structure, the U.S. will not exist as a sovereign nation. Globalism policies will destroy us. The global economy will also be affected by global warming. There may be a question of why we have global warming, but there is no question that there is global warming. This will affect our food supply and many other facets of life on earth. Over a million climate change refugees have already begun. *– Retired School Teacher*
- I believe that the US will adapt itself to the changing global climate and reclaim its position as a leader in the global economy. However, I also believe that a number of other countries will join the US in this leadership role. *– Accountant*
- It all depends on the choice we make.
  (1) If the public and private sectors of our economy work together, communicate with their global peers, and make nonpartisan, well-reasoned judgments that are: (a) grounded on principles of the long-term common good for the US and for our global neighbors; and (b) based on comprehensive, objective data that draws from multiple disciplines, cultural diversity, and lessons learned from history - then we could be a strong participant.
  (2) If the public and private sectors of our economy continue to play in their different sand boxes; talk only among themselves; wear their red and blue tee shirts; construct sand castles to protect themselves from infidel invaders; all the while blissfully unaware of global warming – then we will be a footnote in history. *– Attorney*
- American ingenuity and entrepreneurship will step in to keep our country at least on the playing field. *– Customer Service Employee*
- "But the world has changed and so have I, and America can survive, America can survive!" *– Hank Williams, Jr.*

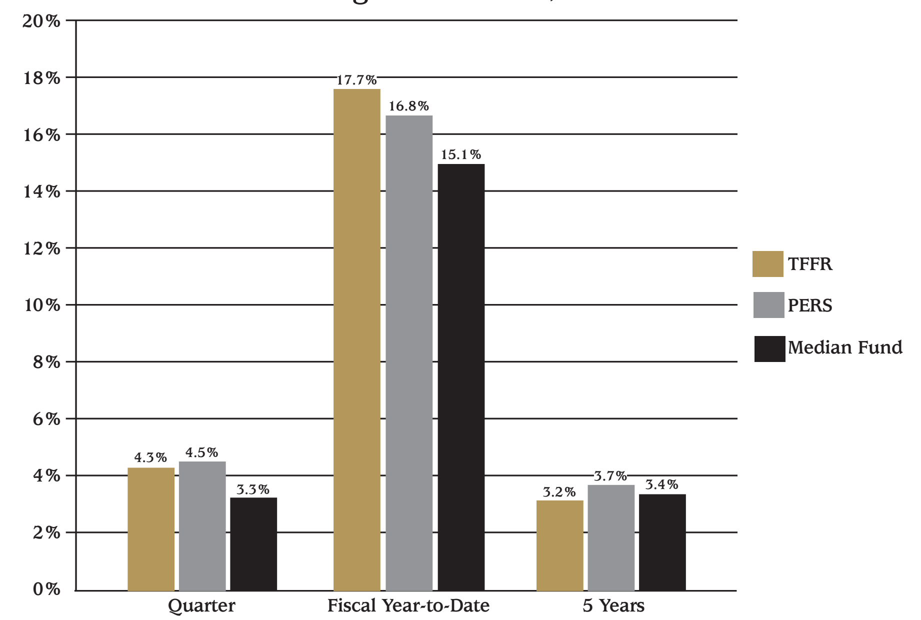
Comments from Investment Officer:

Well, the fiscal year is more than half over. So far, the markets have helped restore some wealth to our PERS and TFFR funds.

Our investment consultant, Callan Associates, measures our funds' returns and then compares them to the results of other public pension plans. In this chart, for the period ending on December 31, 2009, we can see our results for the latest quarter, fiscal year to date (6 months), and for the past five years. The comparison universe has grown to 105 public funds. You can see that the PERS and TFFR have done better than the median public plan this year. In fact, both of our plans ranked in the top 5% of the "Callan Universe" of 105 funds during this past quarter. Fiscal year to date returns fall in the top quartile! For the longer, 5-year period, we look a lot like our friends in the rest of the country, with our funds providing tight boundaries to the median return.

As we all know, this past decade has been very poor for investors. At least we have strived to make the best of a very challenging economic and financial period.

Investment Performance
Periods Ending December 31, 2009



Target Asset Allocation

As of December 31, 2009

	TFFR	PERS
Domestic Large Cap Equity	28%	30%
Domestic Small Cap Equity	10%	10%
International Equity	18%	10%
Emerging Markets Equity	5%	5%
Alternative Investments	5%	5%
Domestic Fixed Income	12%	24%
High Yield Fixed Income	7%	5%
International Fixed Income	5%	5%
Real Estate	9%	5%
Cash Equivalents	1%	1%
TOTAL FUND	**100%**	**100%**

2009 Annual Financial Report Available

The North Dakota Retirement and Investment Office Comprehensive Annual Financial Report (CAFR) has been published and may be viewed from our website, www.nd.gov/rio. 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
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