YOUR VESTED INTEREST

North Dakota State Investment Board October 2011

FROM THE DIRECTOR'S CHAIR

The Debt Addiction

"Promises, Promises"

John Geissinger
Executive Director/CIO

Have you looked at a wallet lately? It is hard to find a wallet that will actually carry cold, hard cash. But, there are lots of slots to hold multiple credit and debit cards. Over the last 30 plus years, debt, or loans, once the tool for "special" uses, now support daily life. When I went off to college in the 70's, I had my first checkbook to pay for tuition, books, and groceries. As an aside, the honor code at school extended to bouncing checks, so balancing the checkbook was a required task for graduation. The purchasing cycle was fairly straightforward, though not necessarily easy. One would work, walk the weekly paycheck to the bank to deposit, and afterwards, write a check for weekly purchases. Or, if a check was not accepted, you would walk back to the bank, stand in line…sometimes a long line…withdraw cash from the bank, walk back to the store and make the purchase. Stores offered layaway plans for items that exceeded current savings, and banks offered "Christmas Clubs." And then something happened along the way….

The corporate travel and expense cards, American Express and Diners Club, which required full payment each month, had competition from what now is Visa and MasterCard. These new cards allowed the users to either pay in full, or extend payment over time with an interest charge on the unpaid balance. Expenditures could be made in advance of earnings! Access to unsecured credit was essentially endless. What a wonderful world!

Attitudes towards debt also changed along with increased access. In fact, accumulating debt in the 70's was viewed as the smart thing to do given the inflationary environment we lived in. Why pay now, when one can pay later with "cheaper" money. Debt was no longer the province of the "deadbeat" down the street; it was the tool of the sophisticated individual…. and governments.

The developments in Europe-Greece, Ireland, Italy, and Portugal-as well as in the US, lead me to believe we have, I hope, reached a tipping point: The

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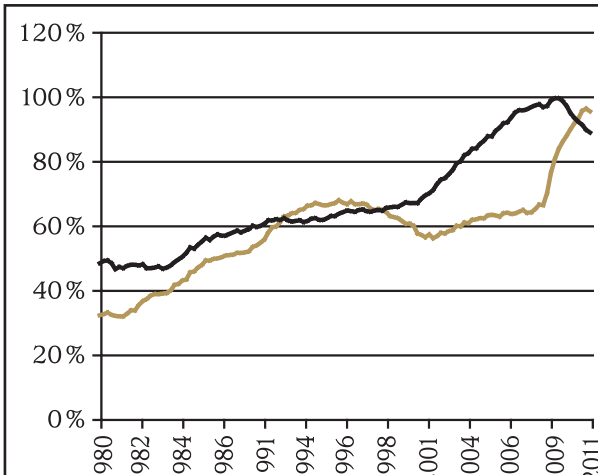

Source: Federal Reserve, Epoch Investment Partners

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The Debt Addiction

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point when an addict acknowledges the problem, and begins the "12 Steps." If the United States is to embark on the 12 Step Program, we must first acknowledge the problem and take a hard look at where we stand today. Mary Meeker, a Partner at Kleiner Perkins Caufield & Byers, published a report in April of this year attempting to do just that (www.kpcb.com/usainc). This report examines the US as if it were a corporation or household, in order to put the debt situation in perspective. A household or a corporation cannot survive indefinitely with expenses greater than income. Yes, they can borrow in the short to intermediate term, but the loans must be paid back or else declare bankruptcy. Income, or revenue, must exceed expenses to survive. How long can a government continue to survive with expenses exceeding revenue?

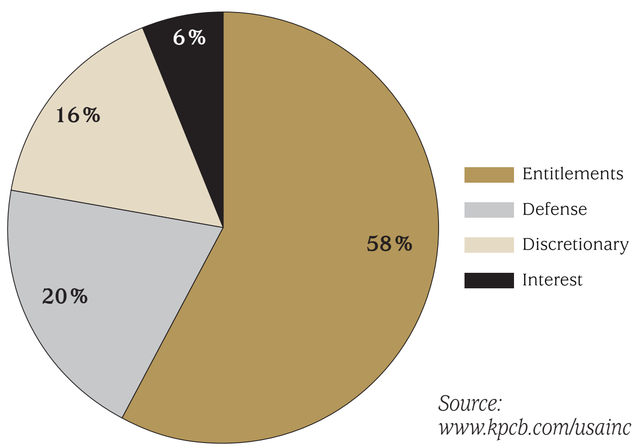
US revenue is in the form of individual, corporate, and payroll taxes, and tariffs on imported goods. The expenses of the US include spending on defense, transportation, education, Social Security, Medicare, Medicaid, and interest on the national debt. While the current budget deficit and debt situation has been grabbing the headlines over the past several months, the reality is US expenses have exceeded US revenue for a long, long time. In fact, expenses have exceeded revenues for all but 5 of the last 45 years, and federal spending, which averaged about 3% of GDP until 1930, has increased consistently to approximately 24% of GDP in 2010. The global addiction to debt has allowed the US to overspend, but how long can this continue?

Mary Meeker's report addresses two questions we should all understand. Why are US expenses growing faster than revenue, and can we isolate and fix the key drivers of revenue and spending?

Without going into great detail, I want to highlight a few key elements of this report. As you manage your household budget, one of the important pieces of information to know is where you are spending your money. So, where does the US spend its revenue? In 2010, 58% of spending was for entitlements-Social Security, Medicaid, Medicare, unemployment benefits, etc., 20% for defense, 16% for non-defense discretionary spending which includes spending on education, infrastructure, and energy, and 6% for interest on debt. The Congressional Budget Office has forecast that Social Security, Medicare, Medicaid, and interest expense will approximate 20% of GDP in 2025. Unfortunately, tax revenue, regardless of marginal tax rates, has hovered just under 20% for decades. Under this forecast, there will be no revenue left over to pay for defense, education, medical research, disaster relief, etc. A dismal forecast at best.

What are ways the US can reverse this trend, and what are the implications for the State Investment Board? There is no magic wand to reverse the financial situation of the US; either expenses need to be reduced, revenue increased, or some combination of both. How does the US increase revenue? The country can't get a second job. As pointed out earlier, tax revenue as a percent of GDP tends to be very sticky around 20%. One could view this as the "tax pain threshold." Trying to generate revenue at a greater percentage leads to tax avoidance strategies: deferring income, bartering, or at the extreme, not working in the US. The good news, however, is tax revenue is sticky at 20% of GDP. When the economy grows, revenue increases. Corporations improve revenue and profitability by increasing the productivity and efficiency of its capital and labor. Can the US do the same? Government spending on healthcare exceeds education spending. Ever-changing regulatory environments and a tax code focused more on providing "behavioral incentives," rather than a focus on generating revenue, hinder economic efficiency. Where is the investment in our future?

Breakdown of Government Spending

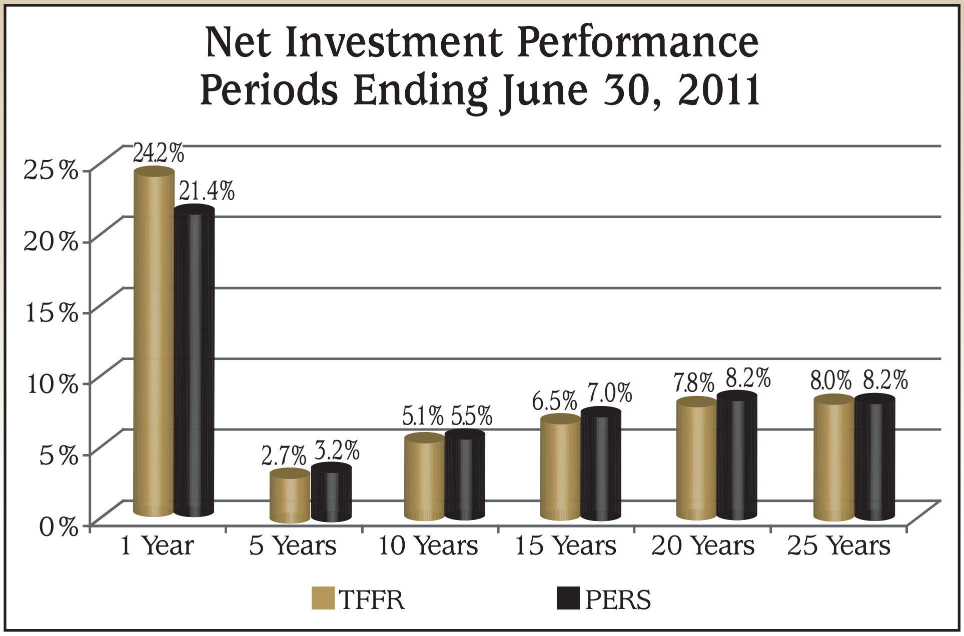


Source: www.kpcb.com/usainc

At the time Social Security was created in 1935, the retirement age was 65, yet life expectancy was 62. Yes, life expectancy was 3 years less than the retirement age! Now, retirement age for full Social Security benefits is 67, an increase in 2 years, while life expectancy has increased 16 years to 78. The solution to Social Security is pretty straightforward. Based upon calculations in USAInc., Social Security can be restored to long-term breakeven by either a) increasing the retirement age to 73, b) increasing the payroll tax from 12.4% to 14.2%, c) reducing benefits by 12%, or d) a combination of the three. (Kudos to North Dakota for following this script in addressing the State's pension systems.)

Unfortunately, the solution to Medicare and Medicaid are not as straightforward. In 1965, 1 in 50 people were enrolled in Medicaid. The number today is closer to 1 in 6, and benefits paid have increased 4 times after factoring in inflation. Government healthcare costs now represent 8.2% of GDP, or the equivalent of the total healthcare expenditures of the 34 OECD (Organization for Economic Cooperation and Development) countries combined. Yet, our return on our healthcare dollar investment is poor compared to these countries. The US ranks among the highest in incidence of obesity and number of heart attacks. Are we getting a good return for our healthcare investment?

The implications for the State Investment Board (SIB) are several fold. Among the leading investment challenges is the increased political risk in Europe and the US, and the resulting impact it will have on financial markets. While political risk has always been a factor in analyzing the emerging economies, the political fallout from the developed world will be significant. Past economic declines have been caused by overleveraged consumers or corporations, which through restructuring, bankruptcy, takeovers, etc., are resolved fairly quickly. Resolving the financial imbalance of governments will take much longer. As a result, the managers hired by the SIB are finding opportunities investing in corporations that generate revenue in the faster growing emerging economies-whether the company is located overseas or in the US is of lesser importance. In addition, our managers have reduced exposure to the dollar in favor of currencies of other, faster growing economies. Our managers are also focusing on companies with a strong ability to generate free cash flow, and solid balance sheets. The demand for capital for infrastructure projects has increased due to the inability of governments to finance this development. Where there is a demand for capital, returns will follow.



Hence, the SIB has reconfirmed the commitment to managers investing in global infrastructure projects. As shown in the asset allocation chart, the SIB will continue to follow a strategy of asset diversification and differing investment strategies in order to weather the pains of withdrawal from our countries addiction to debt.

Target Asset Allocation

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

SIB Audit Committee Re-appointed

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. RIO employs a Supervisor of Internal Audit and one internal auditor.

The Audit Committee meets regularly to conduct essential business and contributes to the 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; Mike Sandal, 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
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Teachers' Fund for Retirement
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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 2011-2012 fiscal year:

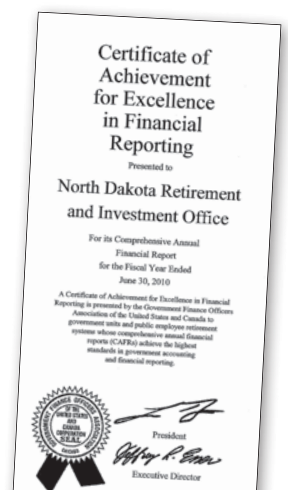
Lt. Governor Drew Wrigley - Chairman

Mike Sandal - Vice Chairman

Clarence Corneil - Parliamentarian

Achievement Award Received

The ND Retirement and Investment Office (RIO) is pleased to announce that its Comprehensive Annual Financial Report (CAFR) for June 30, 2010 has qualified for a Certificate of Achievement for Excellence in Financial Reporting from the Government Finance Officers Association (GFOA).



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, 2010

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

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.