YOUR VESTED INTEREST

North Dakota State Investment Board

March 2012

FROM THE DIRECTOR'S CHAIR

"A little nonsense now and then, is cherished by the wisest men."
~ Roald Dahl, Charlie and the Chocolate Factory

The Return Factory

During my recent meetings with money managers and fellow CIOs, I can't help but wonder if I am watching the latest reality show entitled, "CIOs and the Return Factory." Just as the characters young and old, rich and poor, rushed to the candy stores in search of the Golden Ticket in Willy Wonka, investors worldwide are looking for the Golden Investment, with access to the Return Factory and the Magical 8% Return.

John Geissinger
Executive Director/CIO

Make no mistake, the current investment climate is challenging. Short-term, high quality investments such as Treasury bills, commercial paper, etc. have yields close to zero. That's right, invest money for 6-12 months, and at the end you get your money back. Given this alternative, stuffing the mattress looks like a pretty good idea. As one moves out the risk spectrum, the prospects don't appear any more appealing. The S&P 500 index returned 2.11% for the year ended 2011. The time period matters a lot when looking at equity returns. The equity market returned 11.82% for the fourth quarter of 2011, 14.11% annualized for the last 3 years, but lost 0.25% over the last 5 years. When looking at the output from the "Return Factory," the time period does matter.

I am concerned the investors lined up at the Return Factory have forgotten the benefits of being a long term investor. They are trying to manufacture a specific return year in and year out. The long term investor has become the short term speculator. Hedge funds, promising positive absolute returns in all market environments, continue to gain in popularity. Faced with the prospect of low market returns in the short term, investors have been lured by the promise of "alpha." Successful investors have been shown, through solid analytical analysis and hard work, to outperform the broad markets by 1-2% per year over long time periods, yet investors are looking for more. One CIO for a large sovereign wealth fund was overheard stating his alpha return objective for his hedge fund portfolio was 9%! If you are making assumptions, why stop at 9%, why not assume your managers will outperform by 10%? It reminds me of sitting at my child's parent/teacher conference and hearing how everyone's child is "above average." Think about it, how can everyone be above average? The Return Factory is promising everyone to be above average!

John Wooden, the Men's Basketball coach at UCLA, whose teams won the NCAA Championship 10 times from 1964 to 1975, including winning 7 years in a row, can provide some pointers on how to successfully invest for the long term. John Wooden and his teams were fastidious in terms of preparation, with complete focus on the things under their control. Wooden and his coaching staff did not spend hours analyzing game tapes of their opponents. Time was spent in preparation and focusing on the things under their control, including

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New Asset Allocation Framework

Callan Associates was engaged by the Teachers' Fund for Retirement (TFFR) and the Public Employees Retirement System (PERS) to conduct an asset allocation and liability study for the defined benefit pension plans. Each pension plan has approved a new asset allocation. The pie charts below show the old and new asset allocations for each fund.

The new framework defines broad asset classes (Global) that capture the opportunity set, with clearly defined components that are specific enough to enable clear accounting of market exposures. At the same time, the framework is flexible enough to allow for innovation and the inclusion of new strategies as they arise and are appropriately vetted.

Global Equity

- Domestic – large, mid, small cap
- International – developed - large, mid, small cap; emerging, frontier
- Private equity

Global Fixed Income

- Domestic fixed income
  - — Investment grade
  - — Below investment grade
- International fixed income
  - — Developed markets investment grade
  - — Emerging markets – local currency

Global Real Assets

- Global Real Estate
  - — Domestic – core, value added
  - — International
  - — Publicly traded (REITs)
- Infrastructure
- Timber
- Commodities
- Inflation-Linked Bonds – domestic, international
- Other inflation-sensitive strategies (TBD as opportunities arise)

Global Alternatives

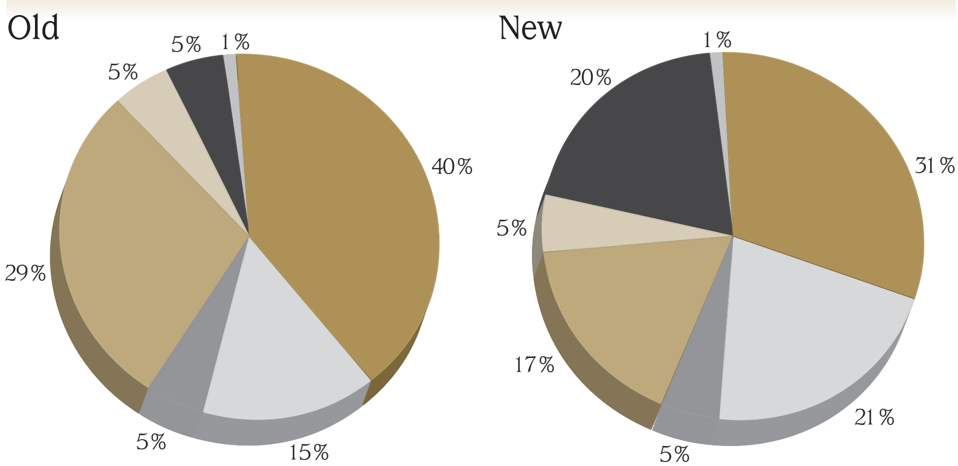
Cash Equivalents

The benefits of the new framework start with a more specific and clear definition of asset classes, where investments are housed under appropriate market categories and true market exposures are more clearly articulated. The framework allows flexibility in the implementation of the investment program by better identifying the full opportunity set. Not all strategies identified must be pursued, and the structure remains open to new strategies as they arise. In essence, the framework divides the portfolio into three basic categories, defined by their reactions to specific capital market factors:

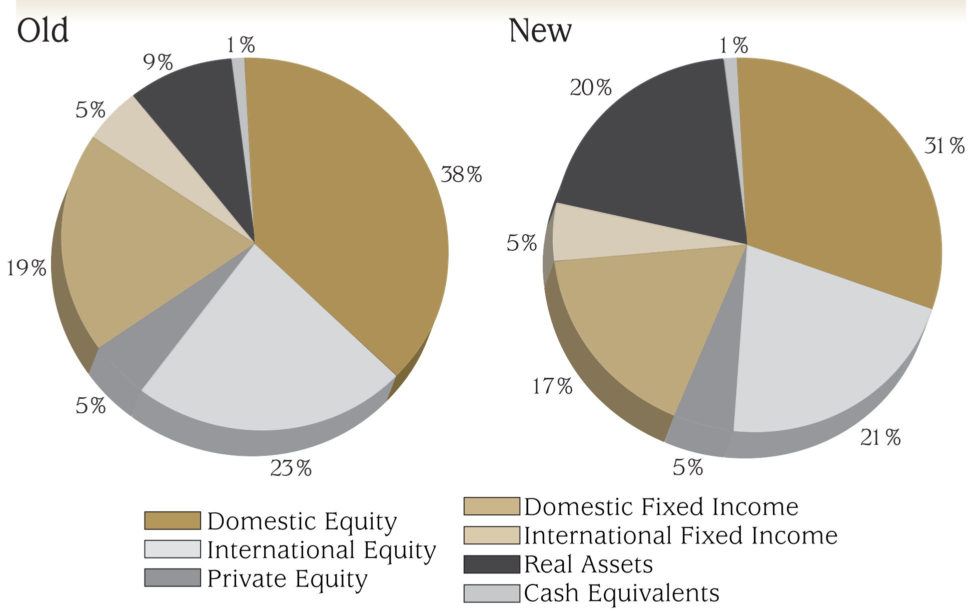
- Equity (growth and capital appreciation)
- Fixed income (income, low risk, flight to quality, deflation)
- Real assets (inflation, income, diversification)

While more detailed than the previous asset class designations, this framework actually simplifies the broad strategic asset allocation into three basic categories. Conveniently, the basic building blocks for implementing this framework are currently in place. In essence, the framework is a new lens for viewing the pension fund's investment program.

PERS Asset Allocation

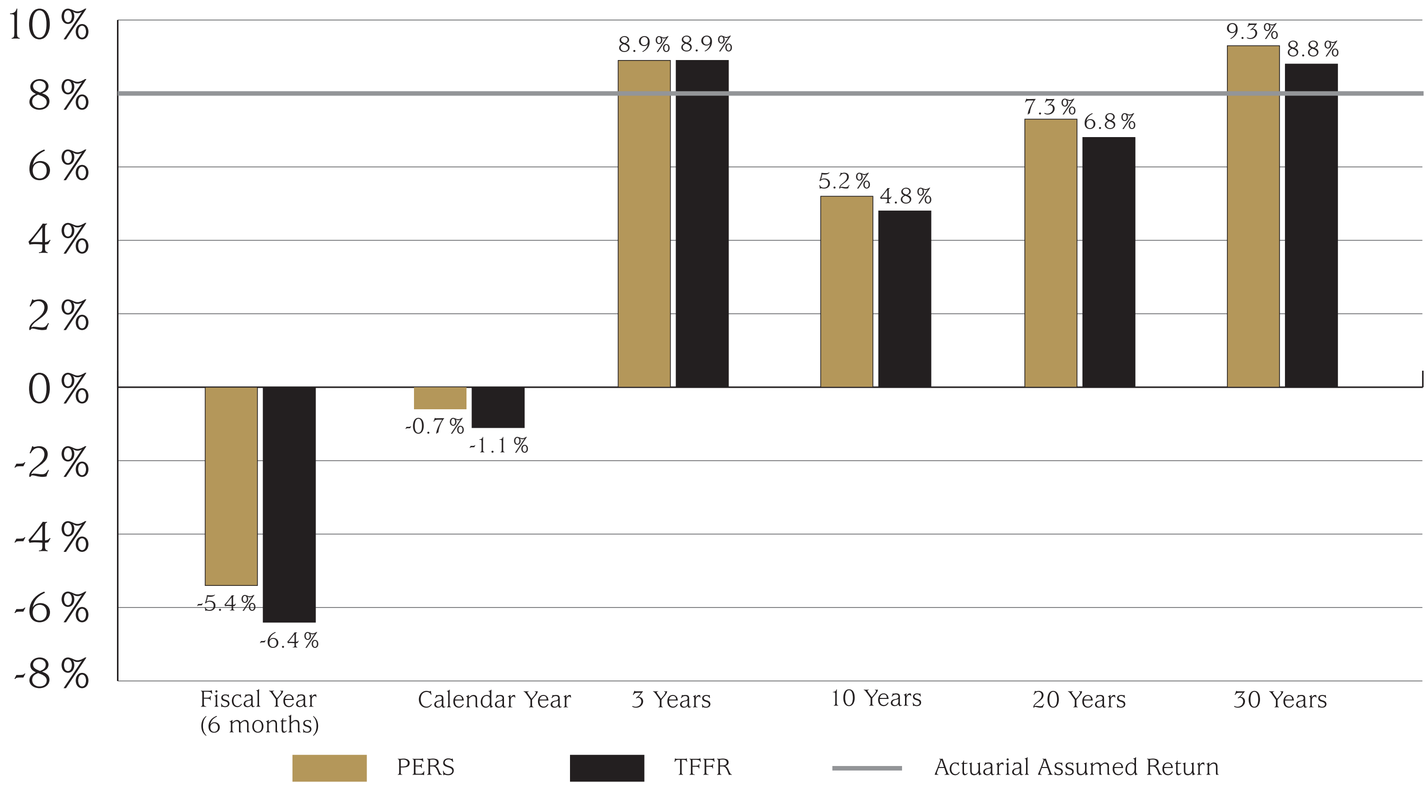


TFFR Asset Allocation



Net Investment Performance

For Periods Ending December 31, 2011



The chart above depicts the net of fee performance for the TFFR and PERS pension funds. The difference in returns for the two funds is a result of different strategic asset allocations. The recent market volatility is exhibited in the variation of returns over different time horizons. As the time horizon lengthens, the returns tend to stabilize around the assumed long-term return.

The Return Factory

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little things. Wooden taught his players how to put on their socks so there were no creases to cause blisters, and kept their hair short to minimize perspiration getting on their hands or impacting their vision. Trivial? Maybe, but it is hard to argue his success. Two of Wooden's maxims continue to stay with me: 1) "Big things are accomplished only through the perfection of minor details," and 2) "The more concerned we become over the things we can't control, the less we will do with the things we can control."

In the game of investing, what are the things that are beyond our control, and what are the things that are within our control? Investors can control the types of risks they are exposed to in the pursuit of investment returns. Bear in mind, investment returns are achieved only through the exposure to different types of risks. Investments that on the surface appear to be risk free may not be. As an example, consider the investment in a 3-month certificate of deposit issued by a bank with FDIC insurance. This investment appears to be safe; principal will be returned in three months and you know in advance the interest you will receive at maturity. But what if your investment horizon is longer than three months? What if it is five years, and you are pursuing an investment strategy of reinvesting in 3-month CDs? If this is the case, you do not know what the future interest rates will be; your rate of return over your investment horizon is unknown. You have taken on reinvestment risk, in what you thought was a risk-free investment.

Investors can control how they diversify across different investment risks, commonly called asset allocation. Investors can also control and manage these risks as realized returns vary over time through a rebalancing strategy. Recognizing the benefits of possessing a longer term investment horizon, the State Investment Board follows a rigorous rebalancing strategy and does not deviate from the asset allocation policies determined by the client funds. When one follows this strategy, and markets are volatile, a benefit accrues to the portfolio: buy low and sell high. Assets that have outperformed are sold to purchase assets that have underperformed. Recognizing that trees can't grow to the sky, the gain from the outperforming asset is harvested and reseeded.

The allure of the Return Factory is tempting. Resist the temptation and focus on the things under your control!

NORTH DAKOTA
RETIREMENT AND
INVESTMENT OFFICE

Teachers' Fund for Retirement
State Investment Board

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RIO Hires Deputy Chief Investment Officer

The North Dakota Retirement and Investment Office (RIO) recently hired Darren Schulz to fill the newly created position of Deputy Chief Investment Officer. He reports directly to John Geissinger, Executive Director and Chief Investment Officer. This position was created by the 2011 Legislative Assembly to provide additional resources and expertise to RIO.

Darren Schulz

Darren has over 15 years of investment management experience. He joins RIO from Wellpoint, Inc., where he held the position of Investment Manager and was responsible for the oversight of the company's defined benefit, defined contribution, non-qualified plans, and foundation assets. Prior to joining Wellpoint, Darren was in the investment consulting business with Morgan Keegan and Tioga Consulting, and spent 9 years in investment management for the Retirement Systems of Alabama.

Darren received his Bachelor's degree in finance from Georgia State University, and is a charter holder from the CFA Institute.

Darren and his wife, along with their young son are getting acclimated to North Dakota. And if you ask them, they don't see why everybody thinks ND winters are so horrible.

2011 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.