YOUR VESTED INTEREST

North Dakota State Investment Board May 2013

# FROM THE DIRECTOR'S CHAIR

## 2012: A Year of Halves

*"Bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria."*

*~ Sir John Templeton*

*The Bank never "goes broke." If the Bank runs out of money, the Banker may issue as much more as may be needed by writing on any ordinary paper.*

*~ Official Rules of Monopoly*

*Darren Schulz*
*Interim Chief Investment Officer*

Calendar year 2012 can be summarized as a year of halves. The first half governed by a host of concerns that dampened investor appetite for risk and the second half distinguished by a rally in risk assets as market anxiety diminished in intensity. For the year as a whole, resilience in the face of adversity seemed to be the overarching theme. The threat of an exit by Greece from the euro, Europe's record unemployment and second recession in four years, Chinese growth that hit a three-year low, and uncertainty about elections here and abroad – such formidable obstacles slowed the progress of the global economy but didn't bring it to its knees.

Debt-related news out of Europe continued to play a major role in global stock and bond markets. Despite cracks in the alliance between Germany and France, the Eurozone finally appeared more willing to take joint action to enforce fiscal discipline. In exchange for new austerity measures, Greece got a reprieve on its deadline for reducing its debt burden. Despite growth that went from explosive to merely robust, China chose new leaders for the next decade who are considered to favor existing policies. In the United States, strong U.S. corporate earnings had begun by year's end to show the toll taken by a slowing global economy. Solid if not robust economic growth, an improving housing market, lower unemployment, and low inflation all had to contend with concerns worldwide about the fiscal cliff.

Though equities certainly experienced some volatility during the year, the stomach-churning declines of 2011 gave way to 2012's more moderate fluctuations and dramatically improved performance. Optimism about the prospects for an economic recovery powered equities to year-to-date highs in the fall, but lost ground in the final quarter as the path to a detour around the fiscal cliff seemed rockier. The S&P 500's 16% gain for the year was a marked improvement over the 2% of the prior year.

Rock-bottom Treasury yields somehow managed to drop even further as the 10-year bond briefly hit a record low of roughly 1.4% in July. Bonds benefitted across the board from investor demand and the Fed's stepped-up quantitative easing efforts.

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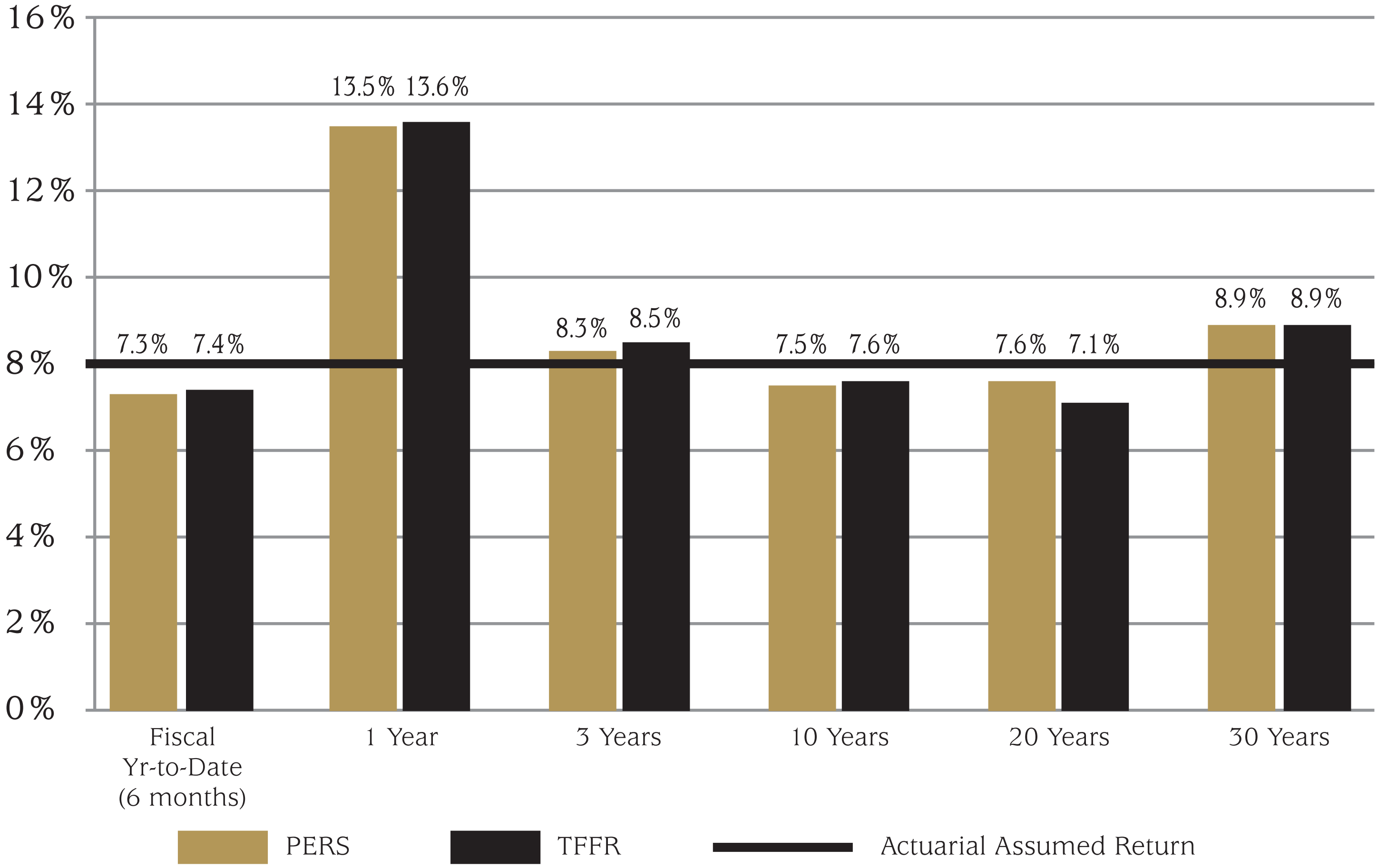
# Net Investment Performance

For Periods Ending December 31, 2012



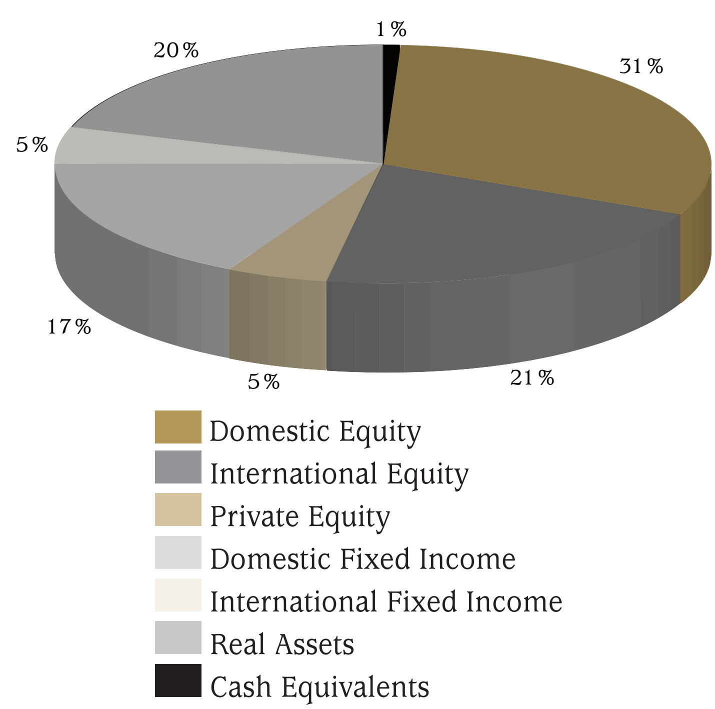

## Performance Observations

1. Following a 5.8% return achieved in the first half of calendar year 2012, the TFFR and PERS plans recorded second half returns of 7.4% and 7.3%, respectively, resulting in a calendar year 2012 return of 13.6% for TFFR and 13.5% for PERS.

2. For the full calendar year, in absolute terms, the following asset class returns were achieved in descending order of magnitude: Below investment grade fixed income, 22.6%; emerging market equity, 19.3%; small cap domestic equity, 18.5%; developed international equity, 17.8%; large cap domestic equity, 17.1%; global equity, 13.6%; infrastructure, 12.1%; investment grade fixed income, 11.1%; international fixed income, 10.1%; private equity, 10.8%; global real estate, 9.5%; and timberland, -1.3%.

3. In relative terms, when compared to their respective benchmarks, both Funds generated outperformance for the year across all asset classes with the exception of timberland, global equity, and global real estate.

## TFFR & PERS Target Asset Allocation



# 2012: A Year of Halves

*Continued from page 1*

The unemployment rate continued to trend downward, ending the year at 7.8%. Though the pace of improvement was frustratingly slow – the jobless rate didn't fall below 8% until September – the employment picture was still better than December 2011's unemployment rate of 8.5%. However, the Fed has forecast only minimal improvement in that figure during 2013, and has promised to keep interest rates low until unemployment hits 6.5%.

Despite a slump in the spring, by the third quarter the U.S. economy was growing at an annualized rate of 3.1% – more than double the second quarter's 1.3% and the fastest growth of 2012. Quarter three corporate after-tax profits were 3.2% ahead of the same time a year earlier. However, growth had begun to taper off in the fourth quarter, driven by reduced government spending and lower inventories.

Modest improvements in the U.S. economy had little impact on prices at either the consumer or wholesale level. At the end of the year, annual consumer inflation was only 1.7% – well within the level the Fed considers acceptable and lower than 2011's 3%. The 1.5% increase in wholesale costs was slightly better, and was far more moderate than 2011's 4.7% wholesale price jump. Consumer spending and retail sales both showed gains for the year, though holiday shopping was slower than anticipated.

While not completely healed, the housing market showed signs that a sustainable recovery was under way. By year's end, sales of new homes had hit their highest level since April 2012 and were 15.3% higher than a year ago, while home resales had their ninth straight month of gains. Home prices were up an average of 7% from a year earlier, while housing starts, construction spending, and building permits all had strung together several consecutive months of improvement.

In conclusion, like the Bank in the game Monopoly, monetary policymakers in the major developed markets have embraced very low interest rates and implemented a number of unorthodox measures in an effort to stimulate economic growth. Whereas in the past, creating money would have involved cranking up the printing presses, today it is simply a matter of adding an extra zero to its own bank account. These unconventional measures are influencing financial markets today, and will continue to do so for the foreseeable future.

# Search for Executive Director/CIO Update

The State Investment Board (SIB) recently hired a search firm to assist them in finding an Executive Director/Chief Investment Officer for the North Dakota Retirement and Investment Office. The SIB had previously appointed Fay Kopp as Interim Executive Director and Darren Schulz as Interim Chief Investment Officer (CIO) of the Retirement and Investment Office (RIO). Although the process to find the right candidate can take time, please be assured the funds entrusted to the SIB are well positioned and are in good hands with a very qualified and experienced staff, board, investment managers, and consultants working together to prudently invest trust fund assets.

NORTH DAKOTA
RETIREMENT AND
INVESTMENT OFFICE

*Teachers' Fund for Retirement*
*State Investment Board*

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## 2012 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.