

# Your VESTED



# INTEREST

North Dakota State Investment Board

March 2004

## REAL ESTATE INVESTING

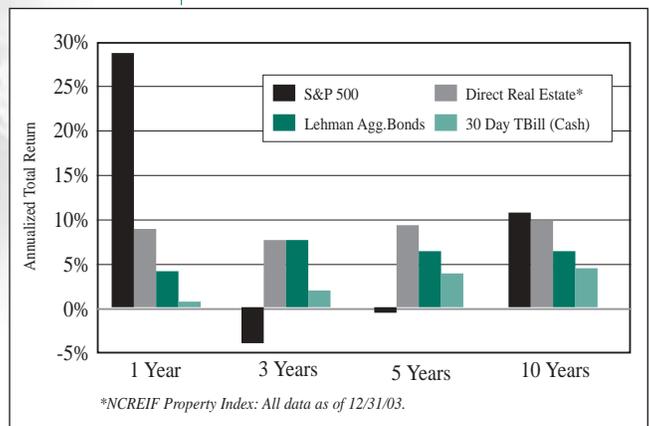
In today's environment of historically low bond yields and volatile stock markets, many are asking, "What other investment alternatives are available?" For many, real estate has emerged as an answer. The North Dakota State Investment Board (NDSIB) has maintained an allocation to real estate for many years. Currently, PERS has 5% invested in real estate while TFFR maintains a 9% allocation.

When the NDSIB invests in real estate, what is it we are investing in? Real estate investing is something that is familiar to many plan participants because many own a home. Plan participants may experience an increase in their net worth if their home appreciates. Similarly, investing in commercial real estate can result in value appreciation, but it also provides current cash flow as a result of the rents that are paid by the tenants. This income that is generated from the portfolio helps to pay the benefits to our retirees.

Commercial real estate comes in many different shapes and sizes. In general terms, the types of properties that NDSIB invests in include office buildings, warehouses, apartments, and shopping centers. The average cost can range from \$7 million to \$50 million or more. Since tenants sign contractual lease obligations for timeframes that typically exceed the normal business cycle, investing in real estate can produce stable returns even though the overall economy and the stock market may be in a downturn. Thus, investing in commercial real

estate can help dampen the swings in the pension plan's overall return performance which helps to diversify the overall risk in the portfolio.

Over the long-term, commercial real estate's performance typically lies somewhere between bonds and stocks on the risk-return spectrum. Over the last 10 years, real estate has provided a competitive total return with much more predictability than either stocks or bonds. During this period, real estate produced an average return of 10% with annual returns that ranged from a low of 6% to a high of 16%. In comparison, the S&P 500 produced an 11% average 10-year return with more volatile annual returns that ranged between -22% and 37%.



While the sluggish economy has weakened many real estate markets across the country, real estate's attractiveness remains intact. Direct, unleveraged real estate generated an annual return of 9% in 2003, and forecasts of new construction are low by historical standards. As the economic recovery builds momentum, real estate will likely follow, aided by rising rents and increasing values in many markets.

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Steve Cochrane, CFA  
Executive Director/CIO

## FROM THE DIRECTOR'S CHAIR

In the last issue of *Your Vested Interest*, we explored the analysis of investment performance by asset class, using the performance charts developed by our investment management consultant, Callan Associates. A quick review of the newsletter would reveal how Callan divides the Pension Trust, in which TFFR and PERS funds are invested, into six distinct asset classes. The fund's performance is then plotted on a set of floating bar charts to compare our "numbers" with those of over 100 public funds measured by Callan representing some \$712 billion in assets. This allows us to gain some insight into how the implementation of our investment program is working relative to a universe of domestic public funds with similar investment objectives and risk constraints.

In this issue, we have printed the floating bar chart by asset class for the most recent 12-month period ended December 31, 2003 (Exhibit 1). Because our last newsletter explained this chart in detail, we will forego such explanation here. As you peruse the chart, you will notice that we continue to show good relative returns across the various asset classes. The extreme outlier in the exhibit is one that works in our favor, "Domestic Fixed Income." The domestic fixed income portfolio's performance ranked in the top 1% of all such investment allocations in the Callan Public Fund Sponsor Database. This is significant at this point in time for reasons most closely related to the economy. With interest rates relatively low, expected future investment returns from bonds become rather pallid. As interest rates ultimately rise, losses in bond values driven by the market pricing mechanism may offset, or more than offset, returns generated by the interest paid by the bonds. Because the State Investment Board (SIB) has anticipated this type of an environment, we have diversified the asset class to provide protection from the

direct loss in value a purely investment grade domestic bond portfolio may expect. Exposure to investments such as convertible bonds, lower quality tranche bonds, and timberland, allow the domestic fixed income portfolio to shine. Under most currently recognized market forecasts, this asset class construction should continue to serve us well.

Another bright spot in the performance is "Domestic Equity." This is important because a large portion of the TFFR and PERS assets are invested in stocks of companies domiciled in the United States. As noted in Exhibit 1, performance has been very good relative to other similar funds and to the "market," as measured by the S&P 500 Index. This asset class has been engineered by the SIB to deliver better-than-index performance while controlling risk. It is exciting and a pleasure to be involved in a program that continues to do what you learn in business school can't be done: consistently outperform the market, even after costs.

In summary, this exhibit from Callan estimates that across all asset classes, our Pension Trust portfolio's weighted ranking is '21', or, in the top 21% of such measures in their database.

This is interesting, of course, but the story actually gets better when we look at the total return for the Pension Trust and for TFFR and PERS, relative to all the funds in Callan's database. This is done on a "gross" basis which ignores investment management fees, to keep the comparison "apples-to-apples" across all of the funds. Fees paid for management do not vary widely among the many funds measured, so the relative ranking information is clearly accurate and revealing. The investment return universe for the one-year period ended December 31, 2003, is presented in Exhibit 2. The Pension Trust, TFFR and PERS per-

EXHIBIT 1

performances are plotted and ranked on the chart. While we must be careful to avoid making extreme statements, it is safe to say that these funds were among the best performing public funds in the United States this past year. As one can see, TFFR ranked in the top 2%, PERS in the top 7%, and not surprisingly, the Pension Trust is in the middle, ranking in the top 6% of all public funds measured. In terms of gross investment return, TFFR gained 28.13%, PERS gained 25.64%, and the Pension Trust was up 26.39% for the calendar year. Asset allocation and strategy within the asset classes propelled these funds to a stunning year.

In understanding the impact of asset allocation to the ultimate investment return, it is helpful to simplify investment exposures into two mega classes we can call "equity" and "fixed income." By understanding the nature of the investments in various asset classes, we can assign each asset class to one of these two mega classes. Exhibit 3 (see back page) graphically portrays how we categorize TFFR and PERS funds in this way. This leads us to some information that improves our insight into investment performance. Notice that this analysis concludes that TFFR is 70% equity and 30% fixed income, while PERS is 60% equity and 40% fixed income. Because calendar year 2003 saw equity returns superior to fixed income returns, the fund with the greater relative equity exposure turned in the higher performance. It is important to note that both pension funds are invested according to their unique actuarial circumstances and the asset allocations, while different, are appropriate to the funds.

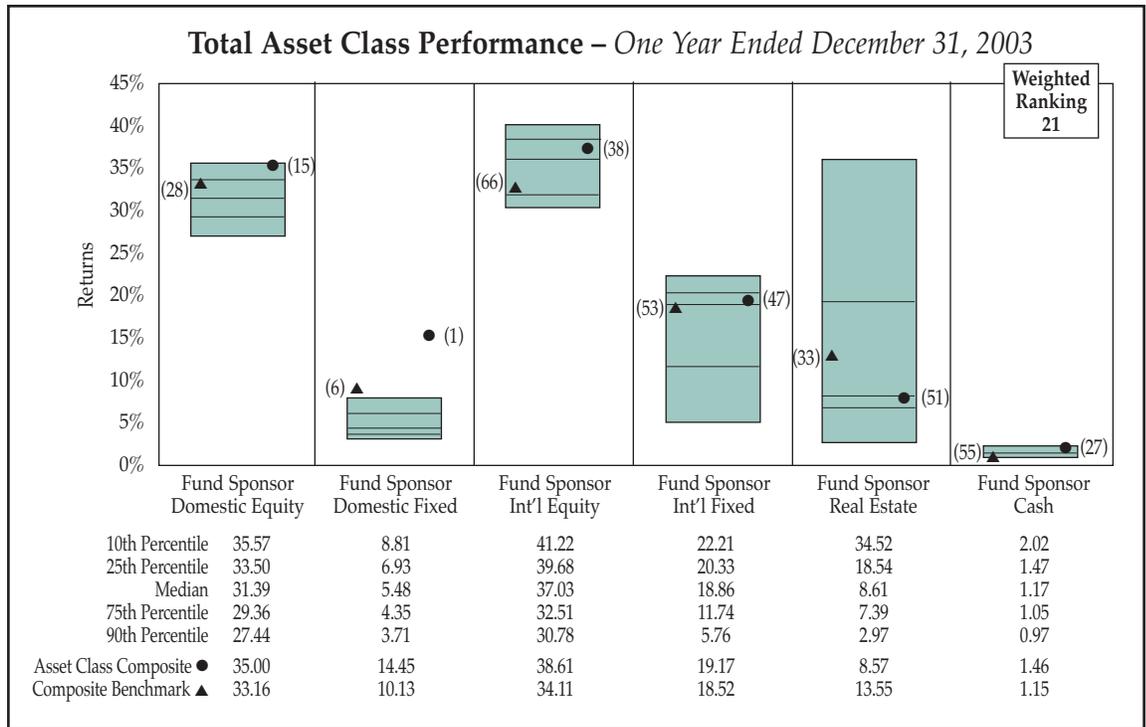
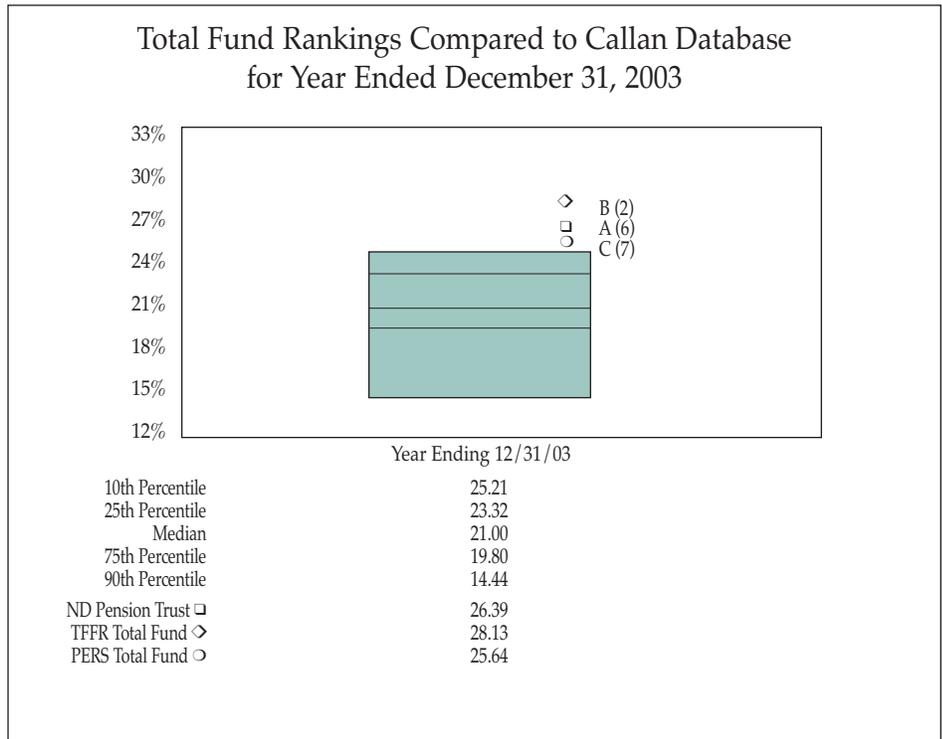


EXHIBIT 2



In summary, it is safe to say that calendar year 2003 was an outstanding year for the investment markets and our funds were at the head of the pack. Will 2004 offer similar experience? I'll let you know two newsletters from now!

# 2003 ANNUAL FINANCIAL REPORT AVAILABLE

The North Dakota Retirement and Investment Office Comprehensive Annual Financial Report (CAFR) may be viewed from our website, [www.discovernd.com/rio](http://www.discovernd.com/rio) or a copy may be requested by contacting the administrative office. This report is a complete review of the financial, investment, and actuarial conditions of the State Investment Board and the Teachers' Fund for Retirement.



The Retirement and Investment Office website contains a wealth of data for the investment programs administered by the State Investment Board including the Public Employees Retirement System, the Teachers' Fund for Retirement and the Workforce Safety & Insurance Fund. Don't miss the opportunity to check out the investment performance, asset allocation, and investment guidelines at [www.discovernd.com/rio](http://www.discovernd.com/rio)

## EXHIBIT 3

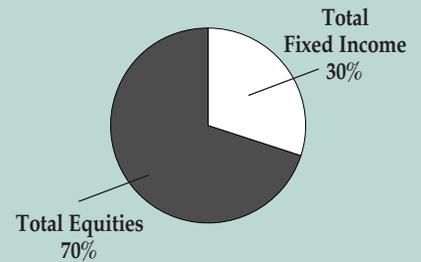
### EQUITIES:

- Large Cap Domestic Equity
- Small Cap Domestic Equity
- International Equity
- Emerging Markets Equity
- Private Equity

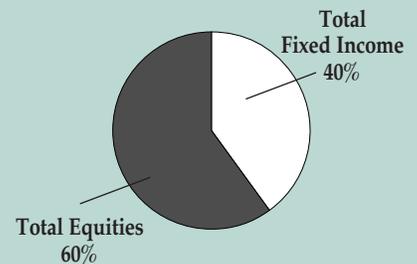
### FIXED INCOME:

- Domestic Fixed Income
- High Yield Fixed Income
- International Fixed Income
- Real Estate
- Cash Equivalents

### ND Teachers' Fund For Retirement Fixed Income to Equity Allocation



### ND Public Employees Retirement System Fixed Income to Equity Allocation



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