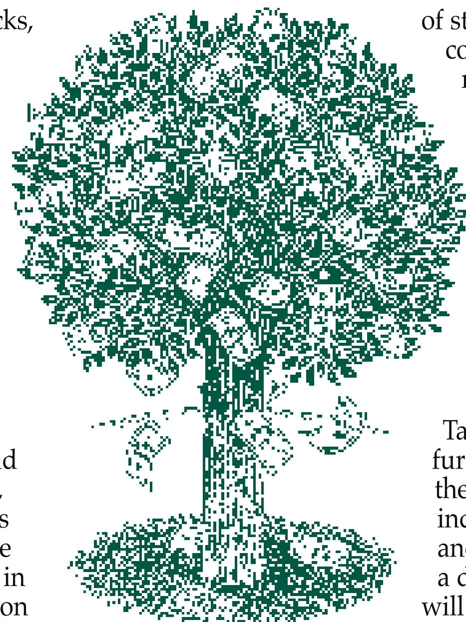
Your VESTED INTEREST
North Dakota State Investment Board
March 2006

ASSET ALLOCATION'S IMPACT ON RETURNS

Asset allocation…think of it as "the forest." Now think of the stocks and bonds and various other individual investments in the Public Employees Retirement System (PERS) and Teachers' Fund for Retirement (TFFR) plans as "the trees." And now you can hear the old adage in your head, "can't see the forest for the trees."

This old saying has a great deal of applicability to investments in general. The pursuit of excellence in investing is often frustrating. Many of us are responsible for making decisions that will have a dramatic impact on our own financial well being. So whether we invest as an occupation, a pastime, or a necessity, we are challenged to differentiate the forest from the trees.

Let's talk about the trees. There are many varieties of trees and they come in many shapes and sizes. In the context of this article, the trees include individual stocks, specific bonds, and the universe of investment managers. Many would agree that the key to a successful investment program is to pick the right stocks, the right bonds, and the right investment managers. Sounds reasonable enough, but is it?



If you are an investor, consider how you construct your portfolio. Is your primary goal to select trees to build your forest? If so, the forest becomes the result of all the trees you planted in it and it will take on the cumulative characteristics of the various trees that comprise the forest. If that is the case, it stands to reason that the investor understood the nature of each tree individually as the forest was built and the ultimate result was planned and pre-determined. That may be a grandiose assumption! But, many portfolios are put together this way and ultimate investment success will be a function of how the forest grew. Let's call this approach, "can't see the forest for the trees."

Let's get to the point and say that the forest is asset allocation. A prudent investment program, whether for an individual or a large defined benefit plan such as PERS or TFFR, begins with appropriate asset allocation. In simplistic terms, we can think of this as the mix of say, stocks to bonds. We all know intuitively that if we had all of our money in stocks, the performance would be much different over time than if we had all of our money in bonds. In between would be a mix of stocks and bonds with correspondingly different results. Research has shown that the variability of investment return is 90% or more explained by this mix, or asset allocation. Put in different words, getting the forest right for your needs is at least 90% of the job.

Taking this one step further, it is logical that the actual selection of individual stocks, bonds, and money managers in a diversified portfolio will explain less than 10% of your ultimate investment return history. Well, doesn't that take all the fun out of cocktail conversation?!

Now that we are focused on the forest, let's relate it to PERS and TFFR. These plans have different underlying liability profiles, so it stands to reason that they have different asset allocations. While they are similar in many respects, there are subtle differences that explain why these two plans generally have different investment returns over any given period.

PERS and TFFR revisit the appropriateness of their asset allocation at least every five years. Both plans conducted asset allocation studies in 2005. As a result, PERS ascertained that the current structure remained consistent with their needs, while TFFR shifted somewhat in its allocation to each of the asset classes within the Pension Trust. Table 2 on page 3 presents the results of these studies.

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FROM THE DIRECTOR'S CHAIR

Steve Cochrane, CFA
Executive Director/CIO

If you are reading this, then you will never be confused again. Are you still with me? I will know by what you say in the future whether you have read this, and I apologize in advance if you say something that is contrary to this message and you did not have an opportunity to review this little piece of op-ed. Ready?

Here is what I hope I won't hear:

"Since the investment program is doing so well, then we must be able to: (a) increase benefits, (b) reduce the cost of funding the plans, or (c) never consider the possibility of boosting contributions."

Ever found yourself saying any or all of these things? If so, you are in the right place and you have the opportunity to continue reading, even if I have offended you already!

Now, this column is meant to be about investments, so I will limit the space allocated to defusing this delusion. Investment success is relative. I would control the markets if I could and we would never have to worry about investment return success again. You could just tell me what you need and I would make it happen. Dream on.

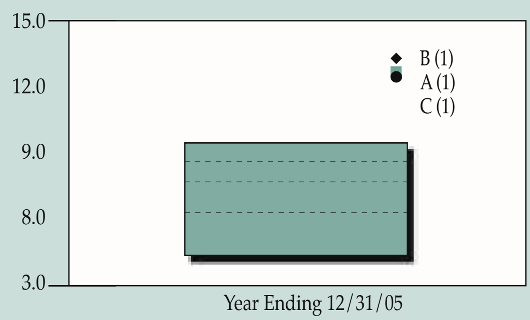
Over the long run, we have to invest in the markets, good and bad. If the stock market is down 10% and our stock portfolio is down 7%, that is good, very good in fact. If we disconnect philosophically at this point, then we come from very different schools of thinking relative to investing assets for institutional pension funds with a very long time horizon.

Now, here is where we have to draw the line between what is good in investing and what is good from an actuarial sense for the funds. Regular readers of this column know that the PERS and TFFR assume that their funds will return at least 8% per year over time. If the fund returns less than 8% in a given year, then from an actuarial standpoint, that is bad. If one of these funds returns even 7% for the year, that would be considered an "actuarial loss." We have to make 8% just to break even! Less than that, and guess who looks like a bum?! PERS and TFFR have two sources of funding, investment return and contributions. So if return is lagging, this puts pressure on the system to the extent that it impacts the underlying liability structure. String two or three years of actuarial losses together and you feel it, and not in a pleasant way. For proof of this, recall that fiscal years 2001, 2002 and 2003 represented years of actuarial losses. The funding status of PERS and TFFR

Table 1

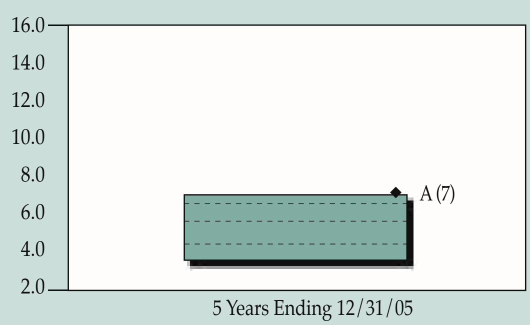
Total Fund Rankings Compared to Callan Database
for Year Ended December 31, 2005

10th Percentile		9.19
25th Percentile		8.22
Median		7.43
75th Percentile		6.23
90th Percentile		4.63
ND - Total Fund - Pension	■ A	12.84
TFFR Total Fund - Gross	◆ B	13.26
PERS Total Fund - Gross	● C	12.70



Total Fund Rankings Compared to Callan Database
for Year Ended December 31, 2005

10th Percentile		6.59
25th Percentile		6.11
Median		5.33
75th Percentile		4.59
90th Percentile		3.91
ND Pension Trust	◆ A	6.66



were affected negatively because their funds returned less than 8% in each of those years. If you were personally invested during those years, you know what I am talking about. The markets have improved since that time, but not enough to offset the damage done. At this point, I feel compelled to once again state that these plans have different actuarial circumstances, and a discussion of these differences is beyond the scope of this article.

Table 2

Asset Allocation

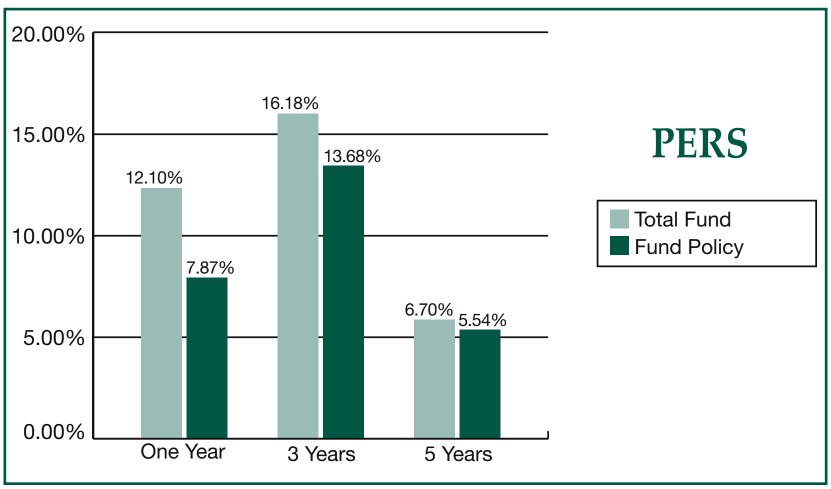
	PERS		TFFR	
	Previous	New	Previous	New
Large Cap Domestic Equity	30.0%	30.0%	30.0%	28.0%
Small Cap Domestic Equity	10.0%	10.0%	10.0%	10.0%
International Equity	10.0%	10.0%	20.0%	18.0%
Emerging Markets Equity	5.0%	5.0%	5.0%	5.0%
Domestic Fixed Income	24.0%	24.0%	7.0%	12.0%
High Yield Fixed Income	5.0%	5.0%	7.0%	7.0%
International Fixed Income	5.0%	5.0%	5.0%	5.0%
Real Estate	5.0%	5.0%	9.0%	9.0%
Alternative Investments	5.0%	5.0%	5.0%	5.0%
Cash Equivalents	1.0%	1.0%	2.0%	1.0%

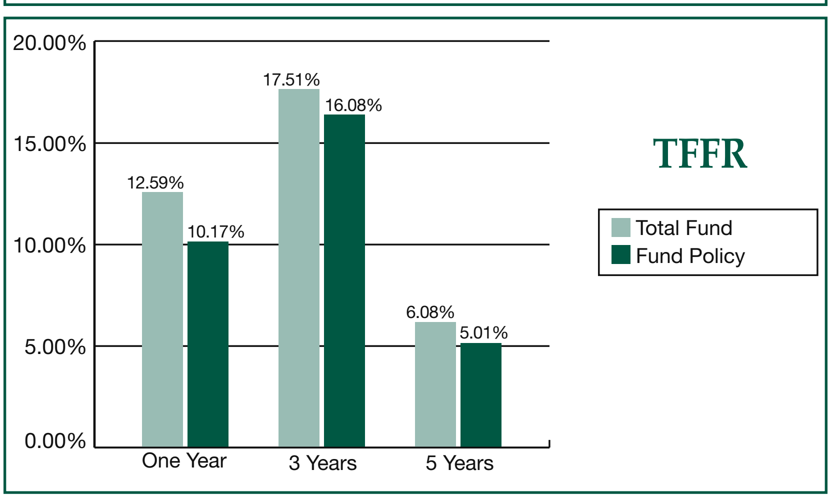
Let's shift to investment success. Here is where we bring the word, "relative," back into play. Our funds are very similar to public employees' and teachers' plans in other states and large cities and counties. (Yes, there are cities and counties much larger than our state!) Because of the similarity in mission and investment programs, our consultant to the SIB provides comparisons of our investment experience with the success of other plans around the country. In fact, we compare ourselves to over 100 other plans representing more than $700 billion in combined assets. The charts in Table 1 relate our TFFR and PERS funds to this database for the one and five year periods ended December 31, 2005. As you can see, both plans rank in the top 1% for the year and the Pension Trust, the vehicle through which the funds are invested, ranked in the top 7% of all funds for performance over the 5-year time frame. On the 5-year look, notice that while relative performance is fantastic, 6.66% (gross) is well below 8%, and therein lies the problem illustrated earlier.

In closing, I would simply add that we have been investing through some very difficult times. We at the SIB have been happy to share the successes of the investment program, but it is important to maintain perspective. We don't expect to always be "on top," nor should we. But we anticipate that over the years, investments will deliver results that are consistent with our plans' asset allocations, and hopefully, continue to add value where possible.

INVESTMENT PERFORMANCE

Periods Ended 12/31/05

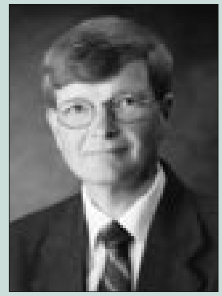




SIB CHANGES

Special thanks to David Gunkel for nine years of dedicated service to the State Investment Board and the SIB Audit Committee. Good luck in your future endeavors.

Rosey Sand will complete Mr. Gunkel's term on the SIB which expires June 30, 2009. Ms. Sand is employed by the ND Office of Administrative Hearings and will represent PERS on the SIB.



David Gunkel

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