March 14, 2008

MEMORANDUM TO: State Investment Council

FROM: William G Clark
Director

SUBJECT: **Proposed Hedge Fund Investments in Knight Vinke Institutional Partners II, L.P., and Marathon Special Opportunities Fund, L.P.**

This due diligence memorandum is presented to the State Investment Council (the "Council") pursuant to N.J.A.C. 17:16-69.9(a) to report on a proposed $100 million equity long/short fund commitment to Knight Vinke Institutional Partners II, L.P. to be managed by Knight Vinke Asset Management in Monaco and New York, and a proposed $100 million direct low volatility fund commitment to Marathon Special Opportunities Fund, L.P. to be managed by Marathon Asset Management in New York.

Please note that these investments will be authorized pursuant to Articles 69 and 100 of the Council's regulations. The Knight Vinke investment will be considered an Equity Long/Short Fund investment and the Marathon Special Opportunities investment will be considered a Low Volatility Fund investment as defined under N.J.A.C. 17:16-100.1.

The Alternative Investments Procedures adopted by the Council on February 21, 2008 require any potential alternative investment opportunities to be identified and initially evaluated by the applicable staff of the Division of Investment ("DOI") and the applicable Asset Class Consultant (Cliffwater LLC for direct hedge funds, or "Cliffwater"), in coordination with the DOI Investment Committee (Director, Deputy Director and the senior staff member for the applicable alternative asset class).

The DOI Investment Committee identified these proposed investments as a result of internal and external sourcing. Cliffwater and DOI staff proceeded to undertake extensive due diligence on the proposed investments. We completed the same due diligence process as with all the other alternative investment opportunities presented to the Council.

Based on this due diligence, the Division has determined that the proposed investments meet the criteria for investments set forth in the Alternative Investment Procedures.

Knight Vinke Asset Management ("Knight Vinke") was founded by Eric Knight in 2003 with $300 million in seed capital from CalPERS. The firm manages $2.6 billion in concentrated, deep-value, activist strategies. Knight Vinke has 18 employees with offices in Monaco (where the majority of investment and research professionals are located), Sacramento, and New York. The firm is a registered investment advisor with the SEC. The firm manages a concentrated, deep-value, activist hedge fund and seeks to identify opportunities and value creation potential through private equity style due diligence. The fund invests in four to six core positions in underperforming large capitalization public companies principally located in Western Europe. Knight Vinke seeks to instigate change by identifying inefficiencies with respect to strategy and/or corporate governance and gathering investor consensus through public campaigns. They offer investors the opportunity to co-invest side-by-side with the fund in certain campaigns. Knight Vinke has produced strong risk-adjusted returns. Since inception in January 2004 to December 2007, the fund has generated an annualized return of 20.15% with volatility of 13.27%, resulting in a Sharpe ratio of 1.51. Due to its concentration the fund will have higher volatility than the average hedge fund. Over this period the HFRI Event Driven Index had a return of 10.98%.

Marathon Asset Management, LLC ("Marathon") is an SEC-registered investment firm with $11 billion in assets spread across six hedge funds and five collateralized debt obligations. The firm's flagship product is Marathon Special Opportunity Fund ("MSOF"), a global distressed securities fund with $2.9 billion in assets under management. Marathon was founded in January 1998 by Bruce Richards and Louis Hanover. Prior to founding Marathon, Mr. Richards was a managing director in charge of trading, investments, and risk management in the fixed income divisions of Smith Barney and at Donaldson, Lufkin, and Jenrette. Mr. Hanover was a managing director at Smith Barney and at Merrill Lynch responsible for trading and risk management in the global emerging markets debt trading divisions. Marathon employs a total of 169 people, the majority of whom work in the firm's headquarters in New York City. MSOF is a global distressed securities fund. The firm combines a top-down, macroeconomic approach with in-depth, bottom-up analysis to identify opportunities with the best risk/reward characteristics. The firm evaluates all components of the capital structure, including an intensive review of covenants, redemption provisions, and other relevant provisions in order to arbitrage the various levels of debt, from the senior-most to the most subordinated securities. In addition to distressed securities, the fund also focuses on capital structure arbitrage and selective short sales. Since inception in May 1999 to December 2007, MSOF has generated an annualized return of 22.35% with volatility of 9.85%, resulting in a Sharpe ratio of 1.74. Over this period the HFRI Distressed Securities Index had a return of 12.06%.

A formal written due diligence report for each of the proposed investments was sent to each member of the Investment Policy Committee of the Council on March 7, 2008, and a meeting of the Committee was held on March 12, 2008. In addition to the formal written due diligence reports, all other information obtained by the Division on these two investments was made available to the Investment Policy Committee.

After a review of the due diligence conducted on each fund, the Investment Policy Committee of the Council decided to report on these proposed investments to the full Council pursuant to Step 3 of the Alternative Investments Procedures. Under these procedures, the Council may adopt or otherwise act on this report.

Attached to this memorandum is the SIC Investment Committee Fund Review Memorandum for each proposed investment.

We will work with representatives of the Division of Law and outside counsel to review and negotiate specific terms of the legal documents to govern each investment. In addition, each proposed investment must comply with the Council's "pay to play" regulation (N.J.A.C. 17:16-4). While we are confident that we will work through these issues, the potential exists that a successful resolution will not be reached with one or both of these managers.

We look forward to discussing these proposed absolute return investments at the Council's March 20, 2008 meeting.

WGC/MK/lt
Attachments