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March 18, 2011

MEMORANDUM TO: State Investment Council

FROM: Timothy Walsh
Director

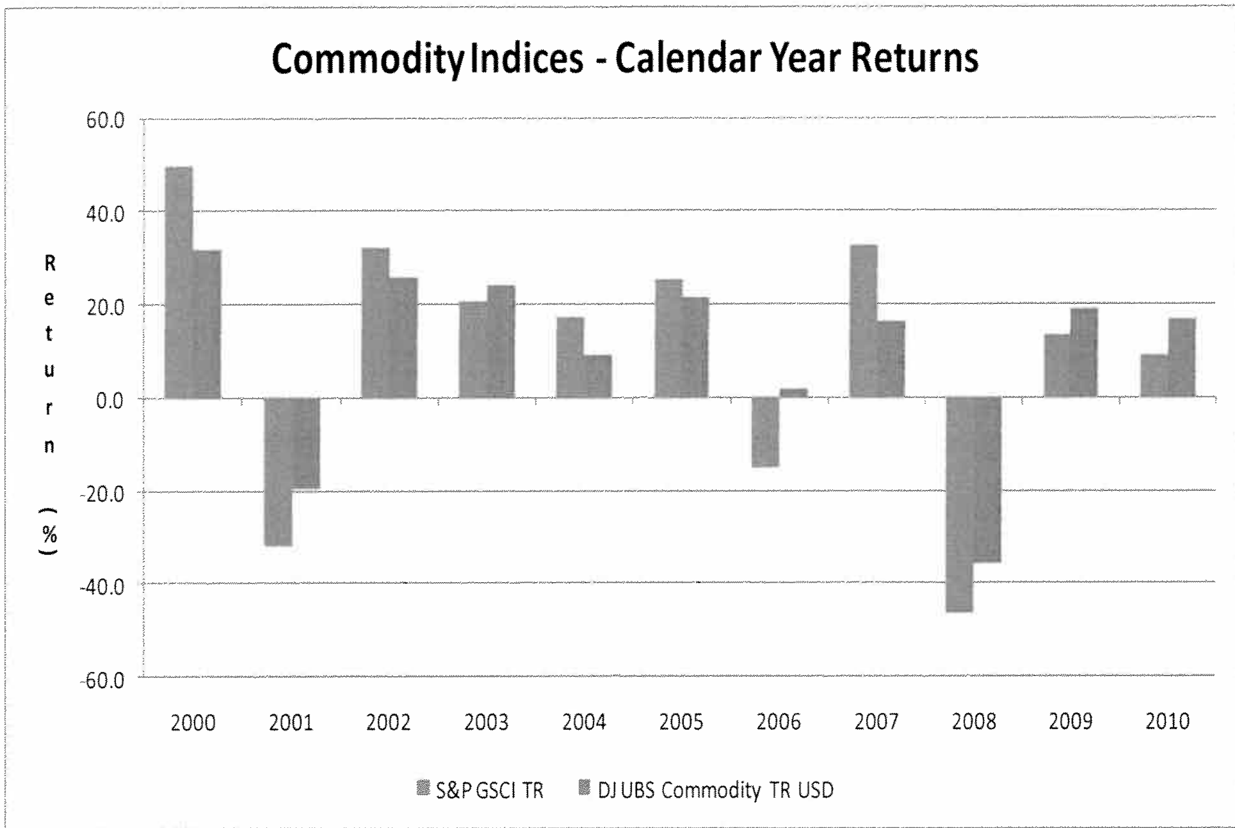
SUBJECT: **Continued Investment in Commodity Linked Notes**

This memorandum is presented to the State Investment Council ("SIC") pursuant to N.J.A.C. 17:16-69.9 to report on proposed continued investments in Commodity-Linked Notes ("CLNs") to be issued by one or more issuers of CLNs that meet minimum standards of creditworthiness, liquidity and organizational capabilities as set forth in this memorandum.

Since 2007, the Division has invested \$850 million in CLNs. The Division currently has two notes outstanding, each with a \$150 million face value, that will mature in April and May of 2011. So far the CLN program has been very successful: as of January 31, 2011, the notes were priced at 1.23x and 1.25x face value. We recently wound down a third note that was set to mature in June since it had already reached its maximum upside. This \$100 million note with Barclays generated a profit of \$19 million since the June 2010 investment and is now in cash.

The Division is advising the Council of its intent to roll forward this \$100 million note and reinvest the two other notes maturing in April and May under the terms defined below. The total amount to be invested pursuant to this request is not to exceed \$500 million, and depending on opportunities may be significantly less.

While we would like to reinvest the proceeds from these notes to maintain our commodity exposure, we are concerned about the recent run up in commodity prices, the overall level of volatility of the traditional commodity indexes, and the susceptibility of the asset class to drawdowns, as displayed by the table below.



A CLN is basically a fixed income security with a fixed maturity date. At maturity, the issuer will pay the initial principal plus or minus the percentage change in the underlying commodity index. Even though CLNs can theoretically trade in the open market, the unique terms of each issue would likely result in the holder receiving less than the intrinsic value of the note on any sale prior to maturity. For this reason, we anticipate holding these CLNs to maturity.

In order to minimize the volatility and lessen the negative impact of a pull-back in commodity prices, we recommend the use of CLNs because they can be structured to mirror the return of a chosen commodity index with some downside protection built in. CLNs also avoid many of the problems related to exchange-traded funds (poor liquidity and high expense ratios) and total return swaps (an ISDA is required). Based on our experience investing in other CLNs, we believe that these investments can be structured and issued efficiently. The downside to CLN's is that one is taking on the credit of the issuer.

Since the exact terms of CLNs change daily depending on market conditions and the risk appetite of the issuer, we are unable to present in advance the specific issuer(s) and precise transaction terms of a CLN. Instead, we wish to obtain the flexibility to invest in one or more CLNs at some point in the future with an issuer or issuers offering the best financial terms and meeting the qualifications outlined below at the time of purchase. We are proposing to purchase CLNs with maturities of up to 2 years. (The current guidelines have a limit of one year but we believe the maturity of two years is warranted and would allow for a payoff profile and fee structure more advantageous to the State.)

Issuer Qualifications

We propose to seek issuers of CLNs that meet the following minimum standards of creditworthiness, liquidity and organizational capabilities:

- **Credit Rating:** We will require a minimum credit rating of A from both Moody's and Standard & Poor's. Our maximum credit exposure to an individual issuer will be based on the issuer's credit rating - $200 million for issuers rated A and above, $350 million for issuers rated AA and above and $500 million for issuers with an AAA rating or above.
- **Market Experience and Expertise:** The issuer should have meaningful experience and expertise in the design and issuance of CLNs. The DOI's general investment consultant will assist in the evaluation of potential issuers' expertise.
- **Legal Support:** The entity should already have the legal ability to issue CLNs as part of their Medium Term Note program and have an existing prospectus that can be evaluated by the Division prior to issuance.
- **Transparent Pricing:** We expect to seek and receive proposals from a number of issuers. We will work with DOI's head trader and general investment consultant to structure the investments with attractive terms that meet the Divisions objectives and will exclude candidates that are unwilling to provide transparent pricing.

Specific CLN Terms

After reviewing sample CLN terms from several issuers, we propose the following specific terms for all CLNs purchased as part of this initiative.

- **Maturity:** Up to 2 years from the date of purchase. (Previous IPC was 1 year)
- **Return:** The note will be structured to provide a return linked to a broad commodity index, such as the S&P/GSCI or Dow-Jones-UBS commodity indices, or to a subset of the commodity market such as metals, energy, or agriculture.
- **Features:** With the large positive move in commodity indexes in the last two years we will try to structure notes with downside protection while preserving upside optionality.

Given that the specific issuer and final investment terms cannot be determined at this time, the Division will report back to the Council on the specific terms of any investments in CLNs pursuant to this proposal if and/or when such investments are finalized.

Please note that this investment is authorized pursuant to Articles 69 and 71 of the State Investment Council regulations. The CLNs are "commodity-linked investments" as defined under N.J.A.C. 17:16-71.1.

We look forward to discussing the proposed investments at the March 24 State Investment Council meeting.