February 13, 2008

MEMORANDUM TO: State Investment Council

FROM: William G. Clark
Director

SUBJECT: **Proposed Investments in Commodity-Linked Notes**

This 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 investment of up to $500 million in one or more Commodity-Linked Notes (explained below).

Please note that these investments will be authorized pursuant to Articles 69 and 71 of the Council's regulations which became effective in June 2005 and were amended in August 2007. These investments in Commodity Linked Notes will be considered Commodity-linked Investments as defined under N.J.A.C. 17:16-71.1.

The Alternative Investment Procedures adopted by the Council on January 20, 2005 require any potential alternative investment opportunities to be identified and initially evaluated by the Head of Alternative Investments of the Division (myself in an acting capacity) and the applicable asset class consultant (in this case SIS) in coordination with the DOI Investment Committee (Ike Michaels, Deputy Director and myself).

Background

As part of the Fiscal Year 2007 Investment Plan, the State Investment Council authorized a target allocation of four percent of the portfolio as of June 2007 dedicated to commodities and other inflation-sensitive assets. The rationale for this allocation was that (1) strong global growth driven by emerging markets countries would cause demand for commodities to increase over a multi-year period, (2) commodity returns often serve as an effective hedge against increases in inflation, and (3) commodities over the long-term are extremely uncorrelated to other investments in the portfolio, thereby reducing the portfolio's overall risk level.

In January 2007, the Division concluded that is was an opportune time to initiate an investment in commodities given that commodity prices had fallen by roughly 20 percent over the preceeding six month period. Since the Division had not initiated a process for retaining external managers for this portfolio, we proposed utilizing up to $500 million in commodity-linked notes to obtain exposure to this asset class.

After presenting this proposal to the Council in January 2007, we invested $450 million in commodity-linked notes in late January and late February 2007. The specific investments, which were made pursuant to the process discussed below, were as follows:

Issuer	Maturity Date	Amount
Lehman Brothers	1/30/08	$125,000,000
Merrill Lynch	1/31/08	$175,000,000
Goldman Sachs	2/28/08	$150,000,000

The notes issued by Lehman and Merrill have both matured, and our total returns through January 31, 2008 for the one-year term were 25.22% and 36.97% respectively. The notes issued by Goldman have returned 29.83% through that date.

During the summer of 2007, the Division initiated a search for external managers to oversee our commodities portfolio. At the September 20, 2007 Council meeting, we presented our recommendations to retain Schroder Investment Management ("Schroder") and Gresham Investment Management LLC ("Gresham") to manage up to $500 million each in actively-managed commodities strategies. In addition to Schroder and Gresham, we indicated that we were continuing to have discussions with a third potential commodities manager that we might recommend at some point in the future. As of January 31, 2008, we had invested $200 million with Schroder and $200 million with Gresham.

Even though we still have additional "capacity" with Schroder and Gresham, we are again proposing to have the flexibility to invest up to $500 million in commodity-linked notes with a term up to one year. Given the volatility in the markets and the four percent allocation to commodities and other inflation-sensitive assets, we believe that maintaining this flexibility will allow us to more effectively "build out" the commodities portfolio.

Recommendation

A CLN is essentially a fixed income security issued off a shelf registration with the SEC. The terms of each CLN are customized to meet the requirements of the purchaser. Issuers of such notes are typically large commercial banks and brokers that have the capability to transact in a broad range of commodity futures contracts and other commodity instruments.

Like any fixed income instrument, the CLN will have a maturity date when the issuer pays the initial principal amount plus or minus the percentage change in the underlying commodity index net of a small adjustment that covers the issuer's cost to hedge the commodity exposure. Even though CLNs can theoretically trade in the open market, the unique terms of each issue would likely result in the seller receiving less than the intrinsic value of the note on any sale prior to maturity. For this reason, we should anticipate holding these CLNs to maturity, which explains why we are proposing to only purchase CLNs with a maturity of one year.

We are proposing to utilize CLNs for this potential investment because they can be structured and issued quickly and they allow for competition among multiple issuers to insure that we obtain favorable pricing on the transaction.

Since the exact amount of this adjustment will change daily depending on market conditions and the appetite of the issuer, we are unable to present in advance the specific issuer(s) and precise transaction terms of a CLN as we have done with other types of alternative investments. Instead we wish to obtain the flexibility to invest in one or more CLNs (with terms defined below) at some point in the future with an issuer or issuer offering the best financial terms at the time of purchase.

Issuer Qualifications

We are proposing to seek issuers of CLNs that meet minimum standard of creditworthiness, liquidity and organizational capabilities. Our issuer qualifications will include the following:

- **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, $300 million for issuers rated AA, and $400 million for issuers with a AAA rating.

- **Market Experience and Expertise –** As evidence of the firm's capabilities in this area, the firm should be among the top ten ranked dealers in commodity derivatives according to Risk Magazine and/or Euromoney as of 2007.

- **Legal Support –** The entity should already have the legal ability to issue CLNs as part of their MTN program, and have an existing prospectus that can be evaluated by the Division prior to issuance.

- **Attractive Pricing –** Since we will seek CLNs with standard industry terms (discussed below), we will be able to seek CLN proposals in competition. The main pricing variable will be the adjustment to the index return that is passed along to the Division in the CLN.

Specific CLN Terms

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

- **Maturity:** One year from the date of purchase.

- **Return:** The note will provide a return linked to the return of a widely accepted commodity index such as the GSCI or Dow Jones-AIG commodity indices. The actual return (either positive or negative) will be adjusted slightly to reflect the issuer's cost to hedge the commodity exposure. This amount of this adjustment and the credit quality of the issuer will be the two competitive factors that will be evaluated by the Division in selecting CLN issuers.

- **Enhanced Roll Strategies:** The Division will consider incorporating an enhanced roll strategy in the CLN proposed by the issuer that offers the potential for somewhat higher returns that the actual index selected. Since all major commodity indices assume that the underlying commodity futures contracts are extended (i.e., "rolled") at the same times each month, certain dealers have developed customized roll strategies that are intended to produce superior returns by rolling the underlying futures contracts at different times of the month. If this option is selected by the Division, the CLN will provide returns linked to the enhanced roll strategy rather than the return on the underlying index. We will insure that the returns on any enhanced roll strategies can be independently verified by the Division.

This proposal was presented to the Investment Policy Committee of the Council at is February 13, 2008 meeting. After reviewing this proposal, the Investment Policy Committee of the Council decided to report on this proposed investment to the full Council pursuant to Step 4 of the Alternative Investments Procedures. Under these procedures, the Council may adopt or otherwise act on this report.

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.

We look forward to discussing this proposal at the Council's February 21, 2008 meeting.

WGC/lt