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MEMORANDUM TO: State Investment Council

FROM: Ray Joseph
Acting Director

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

This memorandum is presented to the State Investment Council (the "Council") pursuant to N.J.A.C. 17:16-69.9 to report on proposed investments of $350 million 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 (explained in Issuer Qualifications, below). Rather than present in advance the specific issuer(s), and the precise transaction terms as done with other types of alternative investments, we ask instead that the Council provide the flexibility to invest the additional $350 million in one or more CLNs (under terms defined below) at the point in the future where we can obtain the best financial terms.

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

Although the Division of Investment (the "Division") has made investments in commodity funds managed by Schroder Investment Management and Gresham Investment Management LLC, the portfolio remains at the low end of the 1% to 4% range allocated for commodities and other real 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. Under current market conditions, an allocation closer to 4% is preferred, prompting this investment proposal.

We believe that this is an opportune time to increase our allocation to the commodities sector. We recommend the use of CLNs, because they avoid many of the problems related to exchange-traded funds and total return swaps, and can be structured to provide the pension funds with returns that mirror a chosen commodity index. Based on our experience investing in other CLNs, we believe these investments can be structured and issued quickly.

A CLN is basically a fixed-income security which will have 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 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. Accordingly, we are proposing to purchase CLNs with a maturity of 1 year.

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 when presenting 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 issuers offering the best financial terms at the time of purchase.

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 or above, $250 million for issuers rated AA, and $350 million for issuers with an AAA rating or above.

- **Market Experience and Expertise**: As evidence of its capabilities, the firm should be among the top 10 ranked dealers in commodity derivatives according to *Risk Magazine* and/or *Euromoney* as of 2009.

- **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.

- **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 propose 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-UBS commodity indices.

- **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 than 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 ensure that the returns on any enhanced roll strategies can be independently verified by the Division.

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.

As with other alternative investments, each CLN issuer must comply with the Council's "pay-to -play" regulation (N.J.A.C. 17:16-4).

The proposed investments were sent to each member of the Investment Policy Committee on March 5, 2010, and reviewed by the Committee at a meeting held on March 10, 2010.

We look forward to discussing the proposed investments at the Council's March 18, 2010 meeting.