



State of New Jersey

DEPARTMENT OF THE TREASURY
DIVISION OF INVESTMENT
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State Treasurer

November 15, 2013

MEMORANDUM TO: State Investment Council

FROM: Christopher McDonough
Acting Director

SUBJECT: **Proposed Investment in Chatham Asset High Yield Separate Account**

The New Jersey Division of Investment ("Division") is proposing an investment of \$300 million in a separate account vehicle with Chatham Asset Management (the "Fund") that will be investing in primarily the same assets on a pro rata basis as the Chatham Asset High Yield Master Fund, Ltd.. This memorandum is presented to the State Investment Council (the "Council") pursuant to N.J.A.C. 17:16-69.9.

The Division is recommending this investment based on the following factors:

Successful Track Record: Chatham's High Yield Master Fund has returned an annualized 8.93% since inception in September 2003 through August of 2013, which is 247 basis points more than the return of the HFRI Relative Value Index in the same time period on an annualized basis. Chatham has also displayed a top-quartile Sharpe ratio on a 1-year and 3-year measurement, as well as since inception. In addition, Chatham has outperformed the S&P 500, the Barclays Agg and the JPM HY index by 181, 415 and 20 basis points respectively since inception on an annualized basis. It should also be noted that Chatham's performance in 2008 was only -2.57% while the HFRI Relative Value Index was -18.04%.

Process-driven Investment Strategy: Chatham's objective is to combine an active trading approach with a bottoms-up, fundamental-based investment process driven by its credit research operation. The firm attempts to identify fundamental and technical inefficiencies in the pricing of leverage credits across the capital structure, while maintaining a keen focus on underlying liquidity. Active trading is central to the strategy and has led to portfolio turnover averaging 1x per month, and allows for the firm to constantly test liquidity and market sentiment. However, specific name turnover has averaged only 5 – 10% per month. This displays the firm's intensive research process and conviction around certain companies and credits while maintaining flexibility to move throughout its capital structure.

Attractive Terms: The Division believes it has negotiated market-leading terms. They are as follows:

- Management Fee: 0.75%
- Preferred Return: 3.00%
- Carry: 20%, calculated over a two year period, further aligning interests
- Optional Redemption: Optional redemption if NAV declines 20% from prior year peak NAV OR if 50% or more of LP assets submits notice of redemption

Disciplined and Respected Investment Manager: Chatham has a track record of returning capital to investors when they do not have an attractive opportunity set, as they did in 2005 – 2006 when they returned \$800 million to investors.

A report of the Investment Policy Committee (“IPC”) summarizing the details of the proposed investment is attached.

Division Staff and its hedge fund consultant, Cliffwater LLC, undertook extensive due diligence on the proposed investment in accordance with the Division’s Alternative Investment Due Diligence Procedures.

As part of its due diligence process, staff determined that the fund has not engaged a third-party solicitor (a "placement agent") in connection with New Jersey’s potential 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 the investment. In addition, the proposed investment must comply with the Council’s regulation governing political contributions (N.J.A.C. 17:16-4).

Please note that the investment is authorized pursuant to Articles 69 and 100 of the Council’s regulations. The Chatham Asset High Yield separate account will be considered a credit-oriented hedge fund investment, as defined under N.J.A.C. 17:16-100.1.

A formal written due diligence report for the proposed investment was sent to each member of the IPC and a meeting of the Committee was held on November 8, 2013. In addition to the formal written due diligence report, all other information obtained by the Division on the investment was made available to the IPC.

We look forward to discussing the proposed investment at the Council’s November 21, 2013 meeting.

Attachments

Fund Name: Chatham Asset Management High Yield Separate Account

November 21, 2013

Contact Info: John Crotty, Chatham Asset Management, 26 Main St, Suite 204, Chatham, NJ 07928

Fund Details:		<p>Key Investment Professionals: Anthony Melchiorre, Founding Partner and Portfolio Manager with 20 years of experience in the High Yield space. Prior to forming Chatham, Mr. Melchiorre was a Managing Director and Head of Global High Yield Trading at Morgan Stanley. Kevin O'Malley, Partner and Portfolio Manager: Mr. O' Malley previously worked in a variety of roles at Morgan Stanley within the Global High Yield Group. Evan Ratner, Partner and Director of Research: Prior to joining Chatham, Mr. Ratner was at DLJ/Credit Suisse for 18 years in investment banking, high yield research and distressed research, most recently as a Managing Director and Head of Distressed Research.</p>
Total Firm Assets (\$bil.):	\$1.5	
Strategy:	Long/Short High Yield Credit	
Assets in Strategy(\$bil.):	\$1.5	
Year Founded:	2003	
SEC Registration:	Yes	
GP Commitment:	1%	

Investment Summary

The Division will be committing to a separate account vehicle that will be investing in primarily the same assets as the Chatham Asset High Yield Master Fund, Ltd. on a pro-rata basis. Chatham will continue to use fundamental company and credit analysis to select high yield debt opportunities and will maintain a relatively concentrated portfolio. Historically, the top 10 positions have made up 55% of the fund. Chatham's four core trading strategies revolve around capital structure, capital market opportunities, tactical allocations and special situations. Much of the investment thesis centers around the expectation of a catalyst within 6-12 months to bring market value in line with Chatham's perceived fundamental value. Asset allocation between high yield bonds and leveraged loans is determined based upon the available opportunities and market views. Chatham's short positions are mostly hedges with a focus on acquiring well-priced insurance, while single name short positions are expected to generate alpha. Chatham invests in liquid instruments to actively manage investment sizes and exposures.

Track Record		
As of 08/31/2013	Fund	HFRI Relative Value Index
1 yr	10.41%	7.29%
3 yr	6.65%	6.28%
5 yr	10.28%	6.15%
Fund Inception	8.93%	6.46%
2013 (thru Aug)	7.88%	3.85%
2012	11.49%	6.36%
2011	-5.99%	-5.25%
2010	15.50%	10.25%
2009	34.73%	19.98%
2008	-2.57%	-19.03%

Fund Inception: 2013
Fund Size (\$mil.): \$300 million
Management Fee: 0.75% on invested capital
Profit Allocation: 20%
Highwater Mark: Yes
Hurdle Rate: 3%
Additional Expenses: 30 bps

Subscriptions: Monthly
Redemptions (notice): Annually (90-day notice after 5th year)
Lock-up: 5-Year Term
Prime Broker: Goldman, Sachs & Co., J.P. Morgan
Administrator: State Street Bank and Trust Company
Auditor: Rothstein, Kass & Co.
Legal Counsel: Seward & Kissel, LLP

NJ AIP Program

Recommended Allocation (\$mil):	\$300 million	LP Advisory Board Membership:	N/A
% of Fund:	99%	Consultant Recommendation:	Yes
		Placement Agent:	No
		Compliance w/ Division Placement Agent Policy:	N/A
		Compliance w/ SIC Political Contribution Reg:	Yes

*This review memorandum was prepared in accordance with the State Investment Council rules governing the Alternatives Investment Program and the policies and procedures related thereto.