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November 14, 2008

MEMORANDUM TO: State Investment Council

FROM: William G. Clark
Director

SUBJECT: **Hedge Fund Investments in Canyon Special Opportunities Fund (Cayman), Ltd. and GoldenTree Credit 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 two direct hedge fund investments: a $49.5 million commitment to Canyon Special Opportunities Fund (Cayman), Ltd., and a $49.5 million commitment to GoldenTree Credit Opportunities Fund, L.P.

Please note that these investments are authorized pursuant to Articles 69 and 100 of the Council's regulations. These investments will be considered credit oriented fund investments 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 for hedge fund investments) in coordination with the DOI Investment Committee (Director, Deputy Director, and the Senior Staff member for the applicable alternative asset class).

As a result of internal and external sourcing, the DOI Investment Committee identified these proposed investments. Cliffwater and Division staff proceeded to undertake extensive due diligence on the proposed investments. We completed the same due diligence process as with all other alternative investments 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 Investments Policy.

Given the size and circumstances surrounding these investments, the Division utilized provisions specified under N.J.A.C. 17:16-69.9(a)(3) and funded these investments in October, 2008. Pursuant to the Council's procedures, this memorandum is for informational purposes only.

As you may recall, the Division presented a proposed $100 million investment in Canyon Special Opportunities Fund and a $100 million investment in GoldenTree Credit Opportunities Fund at the Council's September 2007 meeting. These investments were part of a broader strategy to invest in bank loans made by commercial and investment banks to help finance corporate acquisitions and for other corporate needs. Because of the dislocations in the credit markets that began with subprime mortgages in July 2007 and eventually spread to the bank loan and the high yield market, bank loans traded at significant discounts to par value. These loans offered attractive yields relative to other fixed income instruments and are in the top part of the capital structure offering a higher degree of security than common stocks or most other forms of debt. A number of funds were created in the 2nd half of 2007 to take advantage of this opportunity.

In order to help finance the purchase of these bank loans, Canyon and GoldenTree utilized modest amounts of leverage to enhance returns; Canyon used approximately 1x leverage and GoldenTree used less than 1.5x leverage. The Funds' use of leverage combined with the unprecedented fall in bank loan prices, created a need for additional investor capital to meet loan facility margin requirements. The alternative would have been for the funds to sell a portion of these loans at artificially depressed levels, an option we did not believe was prudent. In order to reduce leverage and avoid the forced selling of investments at distressed prices, both general partners chose to recapitalize their existing funds with additional capital. They plan to use the additional capital to reduce their leverage, meet margin calls and create a significant cushion in their respective financing facilities.

Canyon requested that investors in Canyon Special Opportunities Fund invest an additional 33% of each investor's original investment with the goal of raising $226 million. Given that all investors were not able to participate, Canyon offered investors the opportunity to invest more than their 33% pro-rata share, and New Jersey invested $49.5 million. <u>The new investment is structured as preferred equity providing priority status for redemptions and with no management or performance fees.</u>

GoldenTree requested that investors in GoldenTree Credit Opportunities Fund invest additional capital in the newly created Share Class D, and we chose to invest $49.5 million as well. For investors that chose to participate, the original and additional investments are now in Share Class D. <u>This share class is structured so that investors will pay no management fee on both the prior and new investments</u>. <u>Additionally, no incentive fees will be charged on the entire investment unless and until the fund achieves a cumulative return of 30%.</u> The lock-up period was also reduced to a one year.

An informational written due diligence report for these investments was sent to each member of the Investment Policy Committee of the Council on November 7, 2008, and these investments were discussed during the Committee's November 12, 2008 meeting. In addition to the formal due diligence report, all other information obtained by the Division on these investments was made available to the Investment Policy Committee.

We have worked 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 has complied with the Council's "pay to play" regulation (N.J.A.C. 17:16-4).

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Attachments