Key Points and Issues

Director’s Note

While the remainder of this narrative will discuss activity and performance for the current fiscal year ending June 30, 2008, I thought it would be appropriate here to briefly discuss our performance for calendar year 2007. Estimated overall performance for the pension funds was 9.21%, relative to our benchmark of 9.66%. Our performance lagged the benchmark by 45 bp, which was entirely attributable to our underweight position in commodities (which were up by nearly 33% for the year).

Excluding our underweight in commodities, the portfolio outperformed its benchmark in each major asset class. Our domestic equity portfolio (Common Pension Fund A) returned 7.69%, versus the benchmark return of 5.47%. This strong result is attributable to our underweight exposure to financials, and stock selection within our industrial and technology portfolios. For domestic fixed income, the portfolio returned 8.41% versus 6.92% for the Lehman Long Government/Credit Index, the new benchmark for the portfolio. Even though we continue to remain short duration versus the index (which hurt performance in a period of declining interest rates), this was more than overcome by our underweight exposure to corporate bonds – particularly in the financials.

Within the international equity portfolio, we returned 11.53% versus MSCI EAFE Ex-Sudan, our custom benchmark for the international equity portfolio. Despite lagging the index earlier in the year, we had an excellent fourth quarter (particularly December) driven by our underweight position in Japanese stocks.

Finally, our hedge fund portfolio was up by an estimated 11.9% net of all fees. The top-performing funds were our funds of funds relationships with Goldman Sachs and Protégé, and our direct hedge fund investment in Archipelago (managed by Wellington).

Total Pension Funds

- Estimated performance for the pension funds for the fiscal year-to-date period is 2.87% versus 3.37% for the Council benchmark. For the month of December, the fund was down 0.36% versus 0.49% for the benchmark. The underperformance relative to the benchmark for the fiscal year to date period is attributable to our underweight position in commodities. Total pension fund assets as of December 31, 2007 were $81.3 billion.

- We were net sellers of $233.2 million of U.S. equities in December. In response to the rise in implied volatility in the market, we wrote covered calls in late December on $350 million of underlying equity positions. Within the international portfolio, we were net sellers of $614.5 million in December. We continue to be large net sellers in Japan (sales of $543.0 million), and have reduced our underweight position in Japanese equities to 8.8% of the portfolio. In
addition, we started to fund two of our external managers for emerging markets equities late in the month. Within the domestic fixed income portfolio, we were net buyers of $146.9 million, consisting primarily of 30-year corporate bonds. Within the alternative investments portfolio (Common Fund E), we funded roughly $249.3 million in commitments during December.

- During December, we transferred $600 million out of Common Pension Fund A (domestic equities). Of this amount, $200 million was transferred into Common Pension Fund D (international) and $400 million was transferred into the pension fund cash balances to fund future pension benefit payments.

**Domestic Equity**

- Performance for Common Pension Fund A for December was -0.45% versus -0.66% for the S&P 1500 Index (the benchmark for the domestic equity portfolio). For the fiscal year-to-date period, Common Pension Fund A returned -0.27% versus -1.81% for the benchmark. Our outperformance in December was attributable to stock selection within the technology sector and our underweight position in financial stocks. The main factors contributing to our outperformance for the fiscal year-to-date period were (1) our underweight position in financial sector equities, (2) stock selection within the industrial and technology sectors and (3) recoveries on securities litigations settlements (which were discussed last month).

- As stated above, net sales of equities within Common Pension Fund A during November were $233.2 million. While sales were spread throughout the portfolio, the major activity was in the industrial and financial sectors. The major sales in the industrial sector were GE, EDO (which was acquired by ITT) and United Technologies. Within financials, the major sales were in Merrill Lynch, Morgan Stanley, AIG, Prudential and Travelers.

- We reduced our put option hedges in reaction to the drop in the U.S. equity markets and the rise in equity-implied volatility in November. We currently have puts that provide protection on $2.2 billion in equities, down from $2.6 billion as of October 31.

- According to Barra’s models, Common Pension Fund A (excluding the cash and put option hedges in the portfolio) has an estimated total risk level (i.e., projected standard deviation of returns) of 12.6%, versus 12.4% for the S&P 1500. The portfolio has a tracking error of 100bp versus the index.
Domestic Fixed Income

- Performance for Common Pension Fund B for December was 0.16% versus -0.05% for the Lehman Long Government/Credit Index (the new benchmark for the domestic fixed income portfolio). For the fiscal year-to-date period, Common Pension Fund B was up 8.18% versus 7.55% for the benchmark. While our relative performance was hurt given that portfolio duration is below that of the benchmark, this was offset by our underweight position in credit risk relative to the overall market. The duration of Common Pension Fund B was 8.89 years as of December 31, 2007 (up from 8.58 years as of November 30), versus 11.23 years for the Lehman Long U.S. Government/Credit Index – the new benchmark for the portfolio.

- We had net purchases of approximately $146.9 million in domestic fixed income securities in December. We had gross purchases of $407.4 million, consisting mostly of 10-year and 30-year corporate paper via the new issue market. Many of these deals came at generous concessions to the outstanding debt of the respective issuer. Names that were purchased include AT&T, Archer Daniels, Transocean and Wells Fargo. Offsetting these purchases were sales of $260.5 million, mostly in 5-7 year U.S. Treasury Notes.

International Equity/Fixed Income

- The equity portion of Common Pension Fund D returned 0.00% in December versus a -2.26% return for the MSCI EAFE Index ex-Sudan (the new benchmark for the international portfolio, which is calculated by the Division and excludes those names deemed ineligible for investment under the State’s Sudan Divestment Law). For the fiscal year-to-date period, the portfolio was up 1.07% versus 0.97% for the benchmark.

- We were net sellers of $614.5 million in international equities in December. The major activity on a geographical basis was in Japan, where we were net sellers of $543.0 million. We continue to reduce our exposure to the Japanese market because we believe that market is closely tied to prospects for global growth. The major activity on a sector basis continued to be in the financial stocks, where we were net sellers of $313.5 million. The major names that were sold include Credit Suisse, UBS, Nomura, Societe Generale, Deutsche Postbank, Barclays and Commerzbank. Other major activity includes sales of Toyota, Groupe Danone, Komatsu and Honda, and purchases of Philips Electronics and Inbev.

- Within international fixed income, the major activity was the purchase of $540 million of short-term JGBs from the proceeds of our Japanese equity sales. We continue to believe that the Japanese yen serves as an effective hedge against the unwinding of the global carry trade.
The following companies, while incorporated in a developed market country, will be classified as emerging market companies based upon our review of the various factors as set forth in the State Investment Council Regulations: Belle International, Central European Media, China Mobile, China Resources Power, Cosco Pacific, CTC Media, Eurasia Drilling, Golden Telecom, Gome Electrical, Hikma Pharmaceutical, Lonmin PLC, Millicom, New Britian Palm Oil, Raiffeisen International Bank-Holding AG, Shanghai Industrial, Shangri-La Asia, and Tenaris.

Alternatives

During December, we funded $249.3 million of commitments to alternative investments. In addition, we closed on three private equity partnerships in December – TPG-TAC, WLR Recovery and Wayzata.

The portfolio’s total investment in “alternatives” as of December 31, 2007 is $7.6 billion, or 9.38% of the total portfolio. Please note that this number includes our commodity-linked investments and some publicly-traded private equity vehicles in Common Pension Fund D (e.g., Conversus, Onex).

Cash Management Fund

Total assets in the Cash Management Fund were $16.9 billion as of December 31, 2007. The current yield is 4.62% for state participants, and 4.52% for “non-State” participants. The yield continues to decline (both yields are down by over 20 bp for the month) in response to recent Federal Reserve actions to reduce the target federal funds rate (4.5% as of November 30, 2007, and 4.25% as of the date of this memorandum).