November 9, 2006

MEMORANDUM TO: State Investment Council

FROM: William G. Clark
Director

SUBJECT: **Proposed Hedge Fund Investments in Davidson Kempner Institutional Partners, L.P.; King Street Capital, L.P.; and Golden Tree Partners, 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 three proposed direct hedge fund investments: a $100 million commitment to Davidson Kempner Institutional Partners, L.P.; a $100 million commitment to King Street Capital, L.P.; and, a $100 million commitment to Golden Tree Partners Fund, L.P.

Please note that these investments will be authorized pursuant to Articles 69 and 100 of the Council's regulations which were readopted on September 5, 2006. The investment in Davidson Kempner Institutional Partners, L.P. will be considered a Low Volatility Fund investment as defined under N.J.A.C. 17:16-100.1; the investment in King Street Capital, L.P. will be considered a Multi-Strategy Fund investment; and the investment in Golden Tree Partners Fund, L.P. will be considered an Opportunistic Fund investment.

The Alternative Investments 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 (Cliffwater, LLC for direct hedge funds, or "Cliffwater") in coordination with the DOI Investment Committee (Ike Michaels and myself).

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 these two proposed investments. We completed the same State Investment Council due diligence process as with all the other alternative investment opportunities presented to the Council.

Based on this due diligence, the Division has determined that each of the proposed investments meets the criteria for investments set forth in the Alternative Investment Procedures.

The proposed funds are well regarded within the institutional investment community, and they are currently willing to accept a limited number of new investors. They all have long and very strong performance records which we believe are attributable to a depth of investment talent and strong internal investment processes.

Davidson Kempner Capital Management, LLC was founded by Marvin H. Davidson in May 1983. Davidson Kempner Institutional Partners Fund for tax-exempt investors was started in May 1995. The firm manages $8.7 billion, of which $7.4 billion is in this event driven strategy. The Fund follows an event driven strategy and primarily invests in merger arbitrage, bankruptcy and restructuring situations. They also invest in convertible arbitrage, event driven equities and distressed opportunities. The firm employs a bottom-up approach based on extensive research and understanding of factors affecting the future performance of the company and the industry sector. They typically do not use leverage. The firm has over 30 investment professionals, two risk management professionals and 20 operations and back office personnel. The fund has a low management fee of 1% which is slated to rise to 1.5% on January 1, 2007 for new investors; investors who enter the Fund prior to January 1, 2007 will be grandfathered at 1%. The Fund's performance has been very strong, and has returned 12.68% for the year-to-date period through September 30, 2006. Since inception, the annualized return and the standard deviation through September 30, 2006 were 10.78% and 2.72%, respectively.

King Street Capital, L.P. is a distressed/event driven hedge fund, which was started by Francis Biondi and Brian Higgins in April 1995. The firm manages $6.7 billion in a single strategy. They deploy a long/short approach to distressed and event driven situations and seek to generate positive alpha from both long or short positions. They also invest in capital structure trades. The key risk in the portfolio is the specific issuer risk which is mitigated by a diversified portfolio of core 75 to 125 positions. They make limited use of leverage. The firm has over 50 employees, including 20 investment professionals. The Fund's year-to-date performance as of September 30, 2006 is 8.58%. The annualized return since inception to September 30, 2006 is 14.93%, with 4.29% annualized standard deviation.

Golden Tree Asset Management was founded in March 2000 by Steven Tananbaum, Leon M. Wagner, Steve Shapiro and Tom Shandell. The firm was established as a high yield investment management fund; the flagship fund is the Golden Tree Partners Fund, L.P. that currently has over $3.1 billion in assets under management. The firm has other mandates including a Multi-Strategy fund, and the firm's total assets under management are in excess of $6.8 billion. The firm employs relative value oriented, fundamental, and bottom-up approaches to find mispriced securities. The Fund invests in investment grade bank loans, high yield bonds, middle market loans, mezzanine investments, real estate and equities. The real estate investments consist of equity investments, mezzanine or other real estate loans, bridge and land loans and preferred equity. The real estate related illiquid investments are not expected to go above 15% of the portfolio. The firm employs more than 120 individuals of whom over 44 are investment professionals. Golden Tree Partners Fund, L.P. returned 7.33% year-to-date at September 30, 2006. The Fund returned 13.21% with a 7.30% standard deviation from inception in July 2000 to September 30, 2006.

A formal written due diligence report for each of the proposed investments was sent to each member of the Investment Policy Committee of the Council on November 3, 2006, and a meeting of the Committee was held on November 8, 2006. In addition to the formal written due diligence reports, all other information obtained by the Division on these three investments was made available to the Investment Policy Committee.

After a review of the due diligence conducted on each fund, the Investment Policy Committee of the Council decided to report on these proposed investments 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.

Attached to this memorandum is the SIC Investment Committee's Fund Review Memorandum for each proposed 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 each investment. In addition, each proposed investment must comply with the Council's "pay to play" regulation (N.J.A.C. 17:16-4). While we are confident that we will work through these issues, the potential exists that a successful resolution will not be reached with one or more of these managers.

We look forward to discussing these proposed private equity investments at the Council's November 16, 2006 meeting.

WGC/MK:crb
Attachments