

State Land Board Common School Fund Annual Portfolio Review

Purpose

To provide the State Land Board an update on the performance, structure, and asset allocation of the Common School Fund for periods ended December 31, 2007

Market Background

The second half of 2007 was marked by a dramatic increase in overall market volatility, with both active equity and fixed income markets negatively impacted. Particularly hard hit were quantitatively oriented equity strategies. "Quant" strategies are computer trading models that generally screen stocks on value indicators like low price-to-earnings, earnings quality, and cash flow. As the credit markets were being roiled by the sub-prime crisis, many hedge funds were forced to find liquidity in their portfolios to meet redemption and de-leveraging needs. As liquidity dried up in the credit markets, managers were forced into selling some of their next most liquid instruments, specifically, publicly traded equity securities. Often these "fire sales" were not made because of fundamental issues with the underlying companies, but rather, just to raise cash. As such, high-quality companies (at least based on traditional, and widely used, investment metrics) witnessed unprecedented price declines.

CSF Performance

Within the CSF portfolio, BGI employs a quantitative approach to stock selection for both the domestic and international "Alpha Tilts" products. As of December 31st, CSF had \$553 million and \$254 million in each of these products, respectively. Given the foregoing market conditions, BGI underperformed its respective benchmarks for the year, by a significant margin (over 500 basis points for each product over the past year). It should be noted that OST staff and the OIC's consultant checked the correlation of excess returns of the quants, specifically, to avoid such coordinated downdrafts. Unfortunately, in a market crisis, correlations tend higher. We feel there will be a rationalization of the market and we believe it has already largely occurred.

Nevertheless, given the magnitude of the BGI underperformance, Treasury staff has met with BGI management, and have concluded that some of the previously unique aspects of their investment process have been picked up by other investors. We have since worked with Strategic Investment Solutions, the general consultant to the OIC, to enhance the diversification of the manager line up (see discussion below). In sum, we believe it is prudent to add some additional management styles (i.e., fundamental based portfolios) to the CSF. We expect to complete implementation of the manager changes by May 2008.

Against the backdrop of a flight to quality during the quarter, fixed income did not fare well either. Western Asset Management lagged the Lehman Brothers Universal Index by 232 basis

points for the year, and Wellington Management lagged the index by 100 bps. However, their performance over the past five years has been solid. Western's average performance over the past five years is 159 basis points over the benchmark, and Wellington's is 13 bps, net of fees. As credit markets begin to normalize, we are confident that each manager will see more "normal" performance.

Performance Summary

	MKT VAL \$(M)	%	1 YEAR	3 YEARS	5 YEARS
COMMON SCHOOL FUND (CSF)	1,153,371	100%	2.77	8.29	12.09
<i>CSF Policy Benchmark</i>			7.21	9.40	12.60
TOTAL DOMESTIC EQUITY	553,384	48%	-0.65	7.01	12.45
BGI ALPHA TILTS	553,384	48%	-0.65		
<i>Russell 3000</i>			5.14	8.89	13.63
TOTAL INTERNATIONAL EQUITY	254,711	22%	7.82	16.03	21.17
BGI INTL ALPHA TILTS	254,711	22%	7.82		
<i>MSCI World Ex US**</i>			12.92	17.64	22.29
WELLINGTON MANAGEMENT	155,085	13%	5.50	4.48	4.60
WESTERN ASSET MANAGEMENT	156,415	14%	4.18	4.72	6.06
<i>LB Universal*</i>			6.50	4.64	4.47
CSF PRIVATE EQUITY	8,447	1%			
CASH FUND	25,330	2%	5.41	4.53	3.26
<i>91 Day T-Bill</i>			5.00	4.30	3.07

*Prior to November 1, 2005, index is LB Aggregate

**Prior to November 1, 2005, index is MSCI EAFE

While the short-term relative underperformance of the fund has been painful, the longer-term performance, over the past three and five year periods, has been quite good. In fact, the 12.1% annual rate of return over the past five years is in excess of our long-term expectations for the portfolio.

Asset Allocation and Manager Structure

Presently the Common School Fund is allocated 70 percent to equities and 30 percent to fixed income, using only three managers across four mandates, for a portfolio of approximately \$1.1 billion. Additionally, the equity exposure is currently limited to the domestic and international Alpha Tilts products managed by BGI, as discussed earlier. In an effort to build a more efficient and diversified portfolio, consistent with the general themes embraced by the OIC for OPERF, staff and SIS recommended, and the OIC approved, the following manager changes at their February 2008 meeting:

Implementing a 50/50 US/Non-US equity portfolio structure. Specifically, this would introduce the use of nine existing OPERF equity managers: Wells Capital, MFS, Wanger, Boston Company, Pyramis Select, Arrowstreet, Alliance Bernstein Global Blend, Genesis, and Pictet. Additionally, the private equity component of the account would continue to

“piggy back” on some of the core private equity relationships in the OPERF account (to date: Apollo, Oak Hill, Warburg Pincus, and TPG). While obviously a more complex structure than the existing allocation, the account is expected to benefit from:

- 1) Consistently applying the OIC goal of moving towards global equity allocations for all portfolios.
- 2) Increased style and manager diversification.
- 3) A lower expected tracking error.
- 4) Creates a more efficient portfolio as measured by the information ratio increasing from 0.30 to 0.58.
- 5) The use of existing OPERF manager relationships.

ALTERNATIVE 2	CURRENT	PROPOSED
BGI S&P 500 INDEX		
BGI S&P 500 ALPHA TILTS		\$106.8
BGI 3000 ALPHA TILTS	\$559.8	
WELLS LG		98.6
MFS		98.6
WANGER		32.9
BOSTON CO.SV		16.4
BGI INTL INDEX	261.8	
PYRAMIS SEL		123.2
ARROWSTREET		123.2
GENESIS		28.8
PICTET		28.8
A/B GLOBAL BLEND		164.3
	\$821.6	\$821.6
RISK ANALYSIS		
% LARGE/MID	88.6%	86.9%
% VALUE	50.0	49.5
STYLE RISK	0.00	0.31
ACTIVE RISK	4.00	1.93
RISK TO BENCH	4.00	1.96
ALPHA	1.20	1.13
INFORMATION RATIO	0.30	0.58

- US Large Cap active
- Current OPERF managers
- Well diversified
- Easy to rebalance/monitor
- Efficient portfolio overall
- Higher alpha/risks