

Frequently Asked Questions – State Investment Board (SIB) Investment Program

1) What funds are invested by the SIB?

As of 3/31/10, the SIB has 13 statutory clients (as specified in NDCC 21-10-06 and House Bill 1400, Sections 12 and 49, passed by the 61st Legislative Assembly) and 12 contracted clients. The largest of these include the Teachers Fund for Retirement (TFFR), Public Employees Retirement System (PERS) and the Workforce Safety & Insurance Fund (WSI). Other clients include the City of Fargo Pension Fund, the City of Bismarck Employees and Police Pension Funds, and the State Fire and Tornado Fund. Please refer to the SIB performance summary page which lists the various funds under the SIB.

2) What is the size of the SIB investment portfolio?

As of 3/31/10, the SIB portfolio was comprised of \$3.3 billion in pension funds and \$1.7 billion in insurance funds. Please refer to the SIB performance summary page for the most recent quarter-end market values of the various funds under the SIB.

3) How does the SIB investment program work?

The SIB, with assistance from the RIO staff, implements the investment strategies of the individual clients of the SIB based on the clients' investment policies, which contain their asset allocations. Investments are managed in pools to take advantage of cost efficiencies available to larger pools of money. The SIB externally manages all of its investments, and hires professional investment managers to manage strategies intended to best maximize returns for stated levels of risk within the client policies. The investment managers make the day-to-day decisions on which securities to buy or sell based on investment strategies they are hired to utilize. RIO staff acts as a "manager of managers" and coordinates the activities of the external investment managers, custodian bank and investment consultant. Please click [here](#) (link will be added) to view a diagram of the SIB investment program.

4) What is the prudent investor rule used by the SIB and how does it affect the investments made for my retirement?

According to NDCC 21-10-07, the SIB "shall apply the prudent investor rule in investing for funds under its supervision. The prudent investor rule means that in making investments the fiduciaries shall exercise the judgment and care, under the circumstances then prevailing, that an institutional investor of ordinary prudence, discretion, and intelligence exercises in the management of large investments entrusted to it, not in regard to speculation but in regard to the permanent disposition of funds, considering probable safety of capital as well as probable income."

Chapter 59-17 of the NDCC describes in more detail the prudent investor rule and standards of care. This chapter uses similar language to what is found in The American Law Institute's *Restatement of the Law Third, Trusts: Prudent Investor Rule*, 1992. The General Standard of Prudent Investment, under section 227 of this publication, includes the following:

The trustee is under a duty to the beneficiaries to invest and manage the funds of the trust as a prudent investor would, in light of the purposes, terms, distribution requirements, and other circumstances of the trust. This standard requires the exercise of reasonable care, skill, and caution, and is to be applied to investments not in isolation but in the context of the trust portfolio and as a part of an overall investment strategy, which should incorporate risk and return objectives reasonably suitable to the trust.

In making and implementing investment decisions, the trustee has a duty to diversify the investments of the trust unless, under the circumstances, it is prudent not to do so. In addition, the trustee must conform to fundamental fiduciary duties of loyalty and impartiality, act with prudence in deciding whether and how to delegate authority and in the selection and supervision of agents, and incur only costs that are reasonable in amount and appropriate to the investment responsibilities of the trusteeship.

5) Does the SIB invest in what some would refer to as “risky” investments?

The short answer is no. The SIB controls risk in the portfolios in several ways.

Diversifying the Portfolio

- The pension portfolio is invested in traditional investments such as stocks and bonds. This portfolio has a target allocation of 39% to U.S. stocks and 25% to U.S. fixed income.
- Because today's global economy offers investment opportunities and greater diversification, the pension portfolio has a target allocation of 18% to international stocks and 5% to international fixed income.
- Over the long term, real estate has proven to be an excellent hedge against inflation. Therefore, the pension portfolio has a target allocation of 7% to diversified real estate.
- Because you don't want to put all your eggs in one basket, the pension portfolio also has a target allocation of 5% to what is known as alternative investments. These investments are expected, over time, to add value to the portfolio. Alternative investments actually reduce risk in a total portfolio because they provide diversification from the more traditional investments in the portfolio.
- The pension portfolio also has a target allocation of 1% to cash equivalents securities which is used for short-term liquidity needs.
- In addition to the broad asset classes described above, the portfolios are further diversified through various investment strategies within each asset class.
- There are 41 investment managers with 112 different investment strategies. No more than 6% of the total pension portfolio is invested in any one investment strategy. Therefore, if an investment manager underperforms, or an investment strategy does not perform as expected, it should not have a significant negative effect on the total portfolio.

Hiring Professional Investment Managers

- All the investment managers are registered investment advisers.
- All the investment managers have a proven track record when they are hired.
- All investment managers are continually monitored by the RIO staff and an external consultant.
- The securities the funds invest in are kept in safe keeping in a nationally recognized custodial bank, The Northern Trust. No investment manager is given money to hold until they invest it.

Establishing Investment Guidelines and Policies

- Portfolios are not invested in hedge funds.
- Derivatives are not allowed to be used for speculation purposes. Investment managers use derivatives only as short term substitutes for normal equity or bond positions, such as S&P 500 futures, international stock futures or bond futures. It is a low risk, cost effective way to maintain asset allocation exposure in the stock and bond markets. The goal is to stay within the asset allocation guidelines of the various funds.
- The international investment managers have guidelines that they utilize to control currency risk in the portfolios they manage. The investment managers are not hired to speculate as to what a currency in any particular country, including the U.S. dollar, is going to do against another. The SIB uses a well known international benchmark and measures the investment managers' performance against that benchmark. This allows the investment managers to hedge up to 50% of their portfolios if they deem it appropriate to do so to control currency risk.

6) How have the funds under the SIB performed historically?

Over 25 years, the ND pension funds' net performance has been about 8.5%, which exceeds the actuarial assumed investment return rate. See the [SIB performance summary](#) page for the net of fees performance history of the various funds under the SIB for time periods ended June 30 of each year. RIO, as well as the State of ND, operates on fiscal years (July 1-June 30) rather than calendar years. When comparing investment returns, it is important to understand the time periods reported.

7) How have the ND pension funds done compared to other public pension funds around the country?

In general, the ND pension portfolios have performed better, relative to a broad universe of pension funds, in periods when equities did better than bonds. In the most recent period and over the long-term (25 years), the ND pension funds' performance has been similar to the average public pension fund. This exhibit (link will be added to Callan chart) shows the TFFR and PERS funds' historical returns versus a peer group of currently over 100 public funds as tracked by investment consultant Callan Associates Inc. (CAI). This exhibit uses time periods ended March 31, 2010, the most recent quarter-end available for this database.

It is important to note that during Fiscal Years 2008 and 2009, the stock market (both domestic and international) was down to historically low levels. The domestic stock market, as measured by the Standard and Poor's (S&P) 500 index, was down 13.12% for the fiscal year ended 6/30/08, and down 26.21% for the fiscal year ended 6/30/09. The international stock market, as measured by the Morgan Stanley Capital International Europe, Australasia, Far East (MSCI EAFE) index, was down 10.61% for the fiscal year ended 6/30/08, and down 31.35% for the fiscal year ended 6/30/09.

The returns are all shown before the effect of investment management fees or "gross of fees" as this provides a more accurate comparison within the database of public funds.

8) Investment fees are typically quoted in "basis points." What is a basis point?

One basis point is equal to 0.01% or one one-hundredth of a percent. As an example, if the fees on a fund are \$200 and the total value of the fund is \$100,000, the fees would be 200/100,000 or 0.20% which is 20 basis points.

9) How much is paid each year in investment expenses?

For the fiscal year ended June 30, 2009, the SIB paid investment fees to professional investment firms for management, consulting and custodial bank services totaling 62 basis points (0.62% of total ending market value). Details of these fees can be found in the [2009 Comprehensive Annual Financial Report](#) beginning on page 150. Over the past 25 years, investment expenses for the total SIB program have averaged approximately 44 basis points per year.

The breakdown of fees by trust is as follows:

Pension Trust

For the fiscal year ended June 30, 2009 - 78 basis points (0.78% of ending market value)
Over the past 25 years the fees for the pension trust averaged 48 basis points per year.

Insurance Trust

For the fiscal year ended June 30, 2009 - 46 basis points (0.46% of ending market value)
Over the past 20 years the fees for the insurance trust averaged 23 basis points per year.

Over the past 25 years, the asset allocations of the funds under the management of the SIB have become more diversified and incorporated asset classes with higher return expectations. These asset classes also have higher management fees. The expectation in selecting investment managers is that their returns will add value to the portfolio net of fees.

By way of comparison, the average fee for a mix of public mutual funds with 60% equities and 40% fixed income is approximately 120 bps (1.20%).

10) What causes differences in investment performance among plans?

Studies have shown that 90-95% of the total return of a portfolio is based on asset allocation. All plans have unique asset allocations that are based on the underlying liabilities or cash flow needs of those plans. Which asset classes are performing better, what strategies are employed within each asset class, and how much is allocated to each asset class determines the total performance of the fund. It is important to note that the asset allocation is not determined by the SIB but is set by the clients, such as the PERS or TFFR boards.

11) Is an 8% actuarial return assumption realistic?

Yes. Actuarial return assumptions are long-term in nature and are based, in part, on capital market projections which are obtained from multiple sources. These projections take into consideration long-term historical performance of the various asset classes as well as future long-term expectations in the markets. Currently, the majority of industry experts believe that an 8% return, over the long-term, is achievable.

12) If the stock market performs poorly, how does this affect my pension benefit?

All of the pension funds invested with the SIB are Defined Benefit Plans. This means that your pension benefits are determined by a formula defined as years of service \times average salary \times a multiplier. Fluctuations in the markets do not have a direct impact on your pension benefit; however, it may impact long-term funding available for the plans.

13) Why do different SIB clients have different asset allocations?

Asset allocation is set based on the underlying liabilities or cash flow needs of a fund. Funds that have shorter term cash flow needs (i.e. Insurance Trust clients) generally will have higher allocations to less volatile asset classes such as fixed income and cash equivalents. When a fund is more long-term in nature (i.e. Pension Trust clients), higher allocations to asset classes with more volatility are appropriate to meet long-term return objectives. Because of this, each client sets its own asset allocation.

14) What is the process used by the SIB to hire investment managers to invest pension and insurance trust funds?

Based on the asset allocations submitted by the individual clients, the SIB has created investment pools that clients may participate in. Each pool is made up of various investment managers hired to manage portfolios within those asset classes. RIO staff researches investment managers and brings recommendations to the full SIB for consideration. Representatives from the firm present to the full board, explaining their strategy and methods. A "Due Diligence" profile is completed for reference and fees are negotiated. All new investment management relationships are approved by the SIB.

15) Once investment managers are selected, how are they monitored to ensure they are meeting investment objectives and following investment guidelines?

Prior to funding a new investment manager, investment guidelines specific to the investment strategy are agreed upon and included as part of the contract documentation. Investment management firms have internal departments dedicated to ensuring that all investment guidelines are followed. If a situation arises that causes the portfolio to move outside of the investment guidelines, the investment manager will contact RIO staff and explain the situation. A decision is then made as to whether immediate action is necessary. All such instances are documented.

Additionally, RIO staff monitors the portfolios using both sophisticated software products and various reconciliation procedures. Portfolio performance data is collected monthly from the investment managers. The investment consultant, Callan Associates, Inc., also recalculates the performance of each portfolio based on the custodian bank data. RIO staff then compares the returns provided by the investment managers to Callan's calculations to ensure that all data is reasonable. Investment returns are then compared to benchmarks chosen by the SIB and staff to ensure that the portfolios are performing as expected. Large deviations from benchmarks can indicate that the portfolio is not being managed within original parameters. Investment managers

are brought in at least annually to provide an update on their firms, discuss performance and provide overall economic analysis. If the SIB believes an investment manager is not meeting its stated objectives, they may put them on a "watch list," giving that portfolio added scrutiny for a period of time, until they feel the situation has improved or, when necessary, they terminate the relationship.

16) How many investment managers does the SIB employ?

As of June 30, 2009, the SIB utilized 41 professional investment firms that manage 112 separate investment strategies. A listing of these firms and investment strategies can be found in the 2009 Comprehensive Annual Financial Report beginning on page 62.

17) Why does the SIB employ so many investment managers and have so many investment strategies?

This can be explained in one word...diversification. No more than 6% of the total pension portfolio is invested in any one investment strategy. Therefore, if an investment manager underperforms, or an investment strategy does not perform as expected, it should not have a significant negative effect on the total portfolio.

18) How does the SIB determine in which asset class a potential investment strategy will be used?

Investing is an enterprise where the investor puts capital at risk with the general objective of increasing the value of that wealth within the confines of the investor's risk tolerance. There are essentially two ways that capital can be invested. First, the investor can take an ownership position in the enterprise. This is called equity investing. As an owner, the equity investor has a claim on both the earnings of the enterprise and to the value of the enterprise. The size of those claims is in direct proportion to the investor's share of ownership. Equity investors are typically focused on capital gains rather than income.

The second approach to investing is where the investor lends money to the enterprise. This is called debt investing. Unlike an equity investor who has an ownership interest in the enterprise, the debt investor only has the right to collect a stated rate of interest on the money that was lent to the enterprise. Further, the debt investor is entitled to a return of the amount lent (called principal). The debt investor typically has no claim on the earnings of the enterprise, nor on the value of the enterprise. Debt investors are typically focused on income rather than on capital gains.

There are, of course, exceptions to these rules, but all investments are based on the principles outlined above: you either buy (a percentage) of the investment and become an owner, or you lend it money and become a creditor.

Finally, something that is also taken into consideration is correlation coefficients. Correlation coefficient is just a fancy way of saying how close two different types of investments will perform compared to each other in a given economic environment. If two types of investments perform similarly in up and down markets, they are said to be "positively correlated." Investments that are very highly correlated may be considered part of the same asset class. For example, if a potential investment that may be classified as an alternative investment has a similar correlation coefficient to a fixed income benchmark, consideration will be given to placing the potential investment in the fixed income asset class.

19) What kind of checks and balances are in place to ensure my retirement funds are invested properly?

The SIB as well as the individual pension fund boards employs professional investment and actuary firms to assist them in ensuring the retirement funds are managed appropriately. Asset/liability studies are performed, at a minimum, every 5 years by a 3rd party firm. These studies take into account the underlying liabilities of the pension fund as well as the total assets. These studies result in a range of options considered to be the optimum asset allocation for the fund based on risk and return assumptions.

The SIB also uses a custodian bank, The Northern Trust Company, whose job includes settlement of trades directed by the investment managers, record keeping of all investment transactions and safe-keeping of the assets. The custodian bank is audited annually, including a review of their internal controls and processes.

Audits are also performed annually on all of the investment management firms and any underlying funds or partnerships. The reports on these audits are made available to the RIO office and are reviewed for any issues that may be included in the reports.

An annual financial audit of the RIO office is also conducted (see question 21). RIO's auditors review the audits of the investment firms and custodian bank as well.

An investment consultant is also utilized for 3rd party performance measurement of the investment manager accounts, to assist with investment manager searches and to provide education and other special projects for the board.

20) Is the SIB currently contracted with any companies that it recently found to be under investigation by the SEC or other regulatory agencies, or involved in any legal proceedings?

Yes, the following are currently being monitored for such activities.

WG Trading – The SIB is involved in efforts to recover funds invested in the WG Trading Company Limited Partnership ("WGTC") and other related entities (collectively the "Westridge entities"). The SIB is utilizing the ND Attorney General as its legal representation in this case. In brief, the federal government has alleged that Stephen Walsh and Paul Greenwood of the Westridge entities committed fraud by siphoning money from these investment vehicles for their own use. The SIB is an interested party in four cases brought by the federal government, two civil and two criminal pending in the United States District Court for the Southern District of New York arising from the fraud. NDSIB is among a group of seven public and private pension entities victimized by this fraud and who have banded together to jointly pursue claims. Each of these seven entities made similar investments in WGTC and include the Iowa Public Employees Retirement System, Carnegie Mellon University, University of Pittsburgh, San Diego County Employee Retirement Association, and Sacramento County Employees' Retirement System, among others.

The Court has appointed a Receiver, Robb Evans & Associates, LLC ("the Receiver"). The Receiver has marshaled the assets of the various Westridge entities, issued an initial report regarding the operation of the Westridge entities, and proposed both a claims verification process and a proposal by which it intends to develop an asset distribution procedure for the return of investors' funds to be submitted to the Court. On June 3, 2010, the Receiver filed an additional Report of its Activities for the Period from May 25, 2009 through May 28, 2010. That report further details the Receiver's review of the Westridge entities' operations and the Receiver's conclusions based on that review.

The Receiver has produced documents to the SIB's and its co-claimants' forensic accountant, which our co-claimants have engaged to assist us in evaluating the Receiver's reports and formulating a distribution plan. The forensic accountant is in the process of evaluating the documents received and has provided the SIB and its co-claimants periodic reports on its findings.

The SIB, its seven co-claimants, and representatives of a number of other investor-victims (collectively "the parties") are in communication in an effort to develop and propose to the Receiver a mutually agreeable plan for the distribution of the Westridge entity assets currently held by the Receiver. In furtherance of that effort, the parties intend to submit additional written requests to the Receiver for documents and other data. To accommodate the parties' efforts, the Receiver has agreed to defer the start date of the 45-day clock, pursuant to which the SIB and all investor-victims must submit distribution proposals, until September 1, 2010. However, the Receiver has asked that the parties promptly report if an impasse has been reached on developing distribution

plan, in which case the Receiver will start the 45-day clock before September 1. Additional information is available [here](#).

Although the SIB is not directly affected by the following Goldman Sachs or State Street proceedings, the situations are being monitored by RIO staff and the SIB's investment consultant in the event additional information is found to the contrary.

Goldman Sachs - Goldman Sachs Asset Management manages two mezzanine debt portfolios for the SIB. The SIB is not aware of any improprieties in the management of these portfolios. However, a lawsuit has been filed by the U.S. Securities and Exchange Commission (SEC) against Goldman Sachs as a company, and specifically their Securities Division. In this lawsuit, the SEC alleges Goldman withheld certain information from clients regarding mortgage-related investment vehicles. This lawsuit is focused on the Securities Division of Goldman Sachs which is not directly related to the investment management relationship the SIB has with Goldman Sachs.

State Street - The SIB is a client of State Street Global Advisors (SSgA) in its International Alpha fund. The SIB is not aware of any improprieties in the management of this portfolio. However, the California Public Employees and Teachers pension funds have filed a lawsuit against State Street Bank alleging overcharging for foreign exchange transactions in their relationship as custodian bank. The lawsuit is focused on the custodian business of State Street Bank which is not directly related to the investment management relationship the SIB has with SSgA.

21) Why is the SIB having two audits of the Retirement and Investment Office (RIO) conducted by external independent auditors this year?

Under NDCC 54-10-01, the State Auditor must perform or provide for the financial audits of state agencies at least once every two years. To comply with that requirement, the State Auditor contracts with a public accounting firm to complete a financial audit of RIO each year. Contracts generally cover three fiscal years. RIO is now in the second year of the current three year contract with Eide Bailly LLP. The purpose of the financial audit is to determine whether RIO's financial statements present fairly, in all material respects, the financial position of the fiduciary funds under its responsibility as of and for the year ended June 30 of each fiscal year. The most recent financial audit report of RIO can be found [here](#). The 2010 financial audit report is expected to be delivered in late October.

The SIB has also decided to employ a professional auditing firm to conduct a performance audit of RIO. The objective of this audit is to determine whether the former Executive Director/Chief Investment Officer (ED/CIO) complied with the policies of the SIB, state law and common industry practice and whether there was any irregular financial activity or discrepancies related to that position. The performance audit will include all activities of the ED/CIO, including reasonableness of negotiated fees. The initial time period covered under this performance audit will be July 1, 2009 through April 30, 2010 (the time period since the last financial audit). The initial scope and time frame may be extended based on the audit firm recommendations. An RFP was issued and Clifton Gunderson LLP has been selected to conduct the performance audit. The RFP can be viewed [here](#). The parameters of the performance audit have been established in consultation with the ND State Auditor's Office. The final performance audit report is expected to be delivered August 18, 2010.

22) I understand the SIB hired an interim CIO to oversee the investment program until a permanent replacement is hired. What will the process be?

The SIB has hired LeRoy Gilbertson as interim Executive Director and Chief Investment Officer (CIO). Mr. Gilbertson has extensive experience in the field of public pension plans and investments. Please click [here](#) for the press release regarding Mr. Gilbertson's hiring.

The SIB has formed a Search Committee to find a permanent Executive Director/Chief Investment Officer. An RFP was issued and EFL Associates has been selected to provide executive recruitment services. The RFP can be viewed [here](#). The committee plans to move forward with the recruitment as quickly as possible.

