MINNESOTA STATE BOARD OF INVESTMENT

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DATE: November 9, 2011

TO: Legislative Reference Library

FROM: Howard Bicker

SUBJECT: Investment Consultant Report

As required by Minnesota Statutes, Section 11A.27, attached is the State Board of Investment's Report on Investment Consultant Activities.

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SUBJECT: Report on Investment Consultant Activities

The provisions of Minnesota Statutes, Section 11A.27 require the State Board of Investment to file with the Legislative Reference Library a report on investment consultant activities.

The State Board of Investment (SBI) contracts with Nuveen Investment Solutions, Inc. Chicago, Illinois and PCA, Studio City, California for certain investment consulting services. Nuveen serves as the SBI's general consultant, and PCA serves as the SBI's special projects consultant. The current contracts with these consultants, effective July 1, 2007 to June 30, 2012, call for payment of $370,000 to Nuveen annually and $40,000 to PCA annually.

During the period November 1, 2010 through October 31, 2011, Nuveen was involved in the following projects:

- Availability to the Board, staff and Investment Advisory Council to provide perspective, counsel and input on relevant investment related issues.

- Periodic background information for evaluating SBI investment manager.

During the period November 1, 2010 through October 31, 2011, PCA was involved in the following projects:

- Availability to staff to provide perspective, counsel and input on relevant investment related issues.

Attached is an example of the work product provided.

MEMORANDUM

To: PCA Clients

Date: July 29, 2011

From: Jeremy Thiessen, Principal

RE: Response to Possible Downgrade of U.S. Treasury Debt

Recent economic and financial market news has no doubt been dominated by discussions of the U.S. government debt ceiling. While the debate continues, the outcomes of the events surrounding this issue remain uncertain. Of immediate importance is the possibility of a credit rating downgrade to U.S. debt and how this might affect our client's portfolios as it could potentially force certain holders of U.S. Treasuries (Treasuries) to sell into a strained market. **Therefore, PCA recommends that our clients review their fixed income guidelines to ensure that temporary mechanisms are in place to avoid the forced selling of Treasuries.**

While the debt ceiling has been raised many times in the past, recent news has been dominated by the ongoing debt ceiling debate among lawmakers. Behind these headlines are the following issues, none of which have very certain outcomes.

- Continuing debate among lawmakers on how to resolve the immediate debt ceiling issue
- Possibility of a default by the U.S. government on its debt
- Possibility of a downgrade to the U.S. credit rating

Of particular importance to our client's portfolios is the possibility of the credit rating for U.S. debt being lowered. Recently, rating agencies such as S&P have placed significant pressure on the U.S. government regarding its long-standing AAA credit rating and have warned of the possibility of a downgrade to AA+. PCA is uncertain, however, if such a downgrade would extend across all of the major rating agencies (Moody's, Fitch, A.M. Best) as it appears that S&P's tone is more ominous than the other rating agencies.

PCA views this issue as temporary and recommends as a preventative measure that our clients review their fixed income investment guidelines. Of primary importance is the assurance that guidelines allow client portfolios to continue to hold Treasuries despite a downgrade in credit rating. Recall that during the market events of 2008, many institutional investment managers had significant holdings in mortgage-backed securities, which were under tremendous downward pressure and pricing inefficiencies. During that time, many holders of these securities were forced to sell into a strained market resulting in tremendous losses. For those portfolios that had the ability to weather periods of underperformance, much of the losses were recovered and in most cases with additional upside as markets normalized.

With respect to our client's portfolio guidelines, consideration should be given towards temporarily relaxing restrictions such as requiring that Treasury bond holdings have an average credit rating of AA+ (for example) and adjust this restriction to AA. In similar fashion, guidelines requiring that individual holdings have a minimum credit rating of at least AAA should be adjusted to AA+. Allowing this flexibility will minimize any forced selling of Treasuries into a potentially volatile market. Clients should assess their specific portfolio and guideline needs and address any areas within their fixed income guidelines that contain restrictions relating to credit quality.

Over the next few weeks, the results of the issues highlighted in this memo will come to fruition as markets adjust to the continual release of news items and headlines surrounding U.S. government debt issues. In the interim, reviewing and adjusting portfolio guidelines can provide preventative and temporary measures to mitigate the likelihood that holders of Treasuries be forced to sell due to market noise.

MEMORANDUM

To: PCA Clients

Date: August 9, 2011

From: Pension Consulting Alliance, Inc.

RE: **Comments on Continued August 2011 Market Volatility**

Summary

On Monday, August 8th, the broad U.S. equity market[1] declined by (6.7%). This large sell-off occurred just two trading days after a similar market slide in which the broad U.S. equity market declined by (4.8%) on August 4th. Investor uncertainty and rapid market swings continued to prevail today as the broad U.S. equity market gained 4.7%, despite being down by as much as (1.6%) just hours earlier in the day. Furthermore, the yield on the 10-Year U.S. Treasury Note fell from 2.40% to 2.20% today, a relative yield decline of (8.3%). As evident in recent market activity, especially today in which U.S. equities and U.S. treasuries increased in price simultaneously, global investors appear to have a wide dispersion in regard to their economic outlook. While PCA is not recommending any specific action at this time, we are continuing to monitor these market trends closely.

Discussion

For comparison purposes, out of the nearly 15,500 trading days since January 1950, there have only been 16 days in which the broad U.S. equity market has declined by (6.0%) or more. August 8th ranks as the 12th largest one-day loss for the broad U.S. equity market during this time. Furthermore, out of the over 12,300 trading days since daily data for the 10-Year U.S. Treasury Note has been available (est. January 1962), there have only been 9 days in which the 10-Year Treasury has seen a relative yield decline of (7.0%) or more. The relative yield decline of (8.3%) that occurred today, August 9th, ranks as the 3rd largest since 1962. Additionally, for the two-week period ending today, August 9th, the yield on the 10-Year U.S. Treasury Note declined from 2.99% to 2.20%, a relative yield decline of (26.4%), and the 3rd largest since 1962.

From the end of June through August 9th, the broad U.S. equity market has declined by (11.2%), which places the year-to-date figure for 2011 at a (6.8%) loss. Although the CBOE VIX (Volatility) Index rapidly increased from 16.52 (6/30/11) to 35.06 (8/9/11), PCA doesn't believe that it is likely to approach the 80 mark as it did during the global financial crisis.

Over the last couple of weeks, there have been dramatic changes on both the political and investment fronts. Although the United States government was able to raise the debt ceiling and provide a basic outline for future debt reduction efforts, this agreement was not sufficient enough to avoid a credit rating downgrade from AAA to AA+ by Standard & Poor's. Additionally, despite the downgrade, yields on U.S. government securities have fallen, suggesting that global investors are worried about future economic growth and are thus taking risk off of the table.

[1] S&P 500

Investors appear to be focused on macroeconomic and governmental policy issues, rather than the underlying fundamentals of securities. One of the primary opinions that is being touted by financial professionals and journalists is that in developed nations, we are facing a period of slow, and possibly stagnant, economic growth. Although the European Union has made several advancements in regard to sovereign debt issues, there are still many unresolved challenges and thus investor uncertainty is still prevalent. Similarly, the United States continues to struggle with high unemployment and the issue of government debt is of particular importance.

If the idea of slow, or flat, economic growth for developed nations continues to become more and more widespread, PCA believes that investors may be in store for a new equity trading range. For the S&P 500, this trading range is likely to be somewhere in the neighborhood of 1050 and 1300.

PCA will continue to monitor these market trends closely and provide additional viewpoints on any material issues as they arise. We look forward to discussing these matters with you further within short order. Please do not hesitate to contact your PCA Consultant if you have additional questions or comments.