New Jersey State Legislature
Office of Legislative Services
Office of the State Auditor

Department of the Treasury
Division of Investment

July 1, 2007 to September 18, 2009

New Jersey State Legislature

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The Honorable Jon S. Corzine
Governor of New Jersey

The Honorable Richard J. Codey
President of the Senate

The Honorable Joseph J. Roberts, Jr.
Speaker of the General Assembly

Mr. Albert Porroni
Executive Director
Office of Legislative Services

Enclosed is our report on the audit of the Department of the Treasury, Division of Investment for the period of July 1, 2007 to September 18, 2009. If you would like a personal briefing, please call me at (609) 292-3700.

S. M. Eells

Stephen M. Eells
Assistant State Auditor
December 22, 2009

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Department of the Treasury
Division of Investment

Scope

We have completed an audit of the Department of the Treasury, Division of Investment for the period July 1, 2007 to September 18, 2009. The prime responsibility of the division is the investment of state funds, including the state pension funds, together with the control of principal proceeds and interest receipts. The State Investment Council is responsible for setting the policies by which the division manages the state's various portfolios. The market value of the assets under management on June 30, 2009 was approximately $75 billion. Appropriated administrative expenditures of the division averaged $14.5 million per year. Additionally, the division indicated $143 million and $166 million in brokerage commissions, advisors' fees, and administration of alternative investments were incurred during fiscal year 2008 and 2009, respectively.

Objectives

The objectives of our audit were to determine whether the financial transactions were related to the division's programs, were reasonable, and were recorded properly in the accounting systems. We also tested for the resolution of the significant condition noted in our prior report dated October 18, 2005.

This audit was conducted pursuant to the State Auditor's responsibilities as set forth in Article VII, Section I, Paragraph 6 of the State Constitution and Title 52 of the New Jersey Statutes.

Methodology

Our audit was conducted in accordance with *Government Auditing Standards*, issued by the Comptroller General of the United States.

In preparation for our testing, we studied legislation, administrative code, circular letters promulgated by the Department of the Treasury, and policies of the division. Provisions that we considered significant were documented and compliance with those requirements was verified by interview, observation, and through our samples of financial transactions. We also read the budget message, reviewed financial trends, and interviewed division personnel to obtain an understanding of the programs and the internal controls.

A nonstatistical sampling approach was used. Our samples of financial transactions were designed to provide conclusions about the validity of transactions as well as internal control and compliance attributes. Some sample populations were sorted and transactions were judgmentally selected for testing.

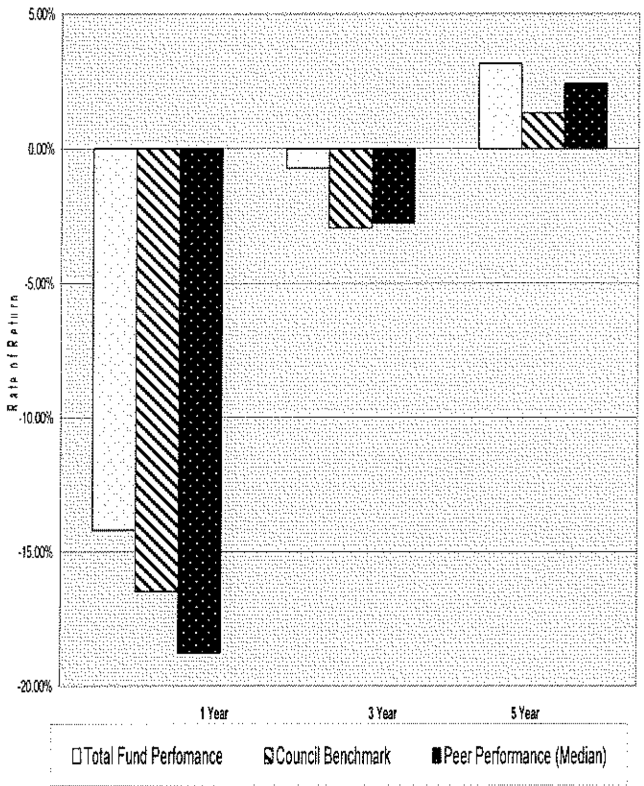
To ascertain the status of the finding included in our prior report, we identified corrective action, if any, taken by the division and walked through the system to determine if the corrective action was effective.

Conclusions

We found that the financial transactions included in our testing were related to the division's programs, were reasonable, and were recorded properly in the accounting systems. We also found the division has resolved the significant issue noted in our prior report. In making these determinations we noted a cost saving measure warranting management's attention.

We obtained an understanding of the investment activities of the division and tested for compliance with state laws and regulations. Our objectives were not to conclude on the appropriateness of any asset class or investment decisions.

The following chart shows the overall investment performance of New Jersey pension funds as of June 30, 2009 in relation to other public pension funds and the State Investment Council benchmark. The median public funds returns were provided by an independent service (unaudited).



External Investment Advisor Fees

Internal management of emerging markets could save between $5 million and $20 million a year.

The State Investment Council, which sets the division's long-term investment policy and strategy, expanded the universe of permissible investments in 2006 to include emerging international markets. Although the division already managed its international developed portfolio internally, current staffing levels were not sufficient to actively manage emerging markets. The division therefore retains external investment advisors to perform research, make recommendations, and initiate trade orders while maintaining final approval authority for all trades.

The division paid approximately $6.4 million in fiscal year 2009 to the emerging markets advisors. If provided with adequate staffing and travel resources, the division could have actively managed the entire emerging markets portfolio for an estimated $5 million less than it paid the advisors in fiscal year 2009. The advisors' fees are based on a percentage of the amount invested; therefore the savings could grow to an estimated $20 million a year if the division increases its emerging markets allocation to its maximum target level. Since the administrative costs of the division are paid from the same funding source as the advisors' fees, the state pension funds, these savings would be reinvested and compounded.

Recommendation

We recommend the Division of Investment be provided with the additional staff and travel resources necessary to forego the advisors' fees and instead actively manage the emerging markets portfolio internally.

State of New Jersey
DEPARTMENT OF THE TREASURY
DIVISION OF INVESTMENT
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JON S. CORZINE
Governor

R. DAVID ROUSSEAU
State Treasurer

December 22, 2009

Mr. Stephen M. Eells
Assistant State Auditor
Office of the State Auditor
125 South Warren Street
P.O. Box 067
Trenton, N.J. 08625

Dear Mr. Eells:

This is in response to the audit report of the Department of the Treasury, Division of Investment (the "Division").

We concur that the pension fund could realize cost savings if even a portion of the fund's emerging market equity portfolio was managed with internal staff. While it is the responsibility of the State Investment Council to set asset allocation for the fund, I believe that our allocation to emerging market equities may increase over time, thereby increasing the cost of external advisors for this portfolio.

That being said, there are several staffing and operational impediments that must be addressed for this proposal to be feasible. These impediments, which already exist for the Division's existing portfolio, would be even more problematic given the unique nature of managing investments in emerging markets countries.

The ability of the Division to successfully manage the emerging market portfolio internally would be dependent on a number of factors:

- Given market compensation practices for emerging market professionals, which include much higher base salaries and bonus programs, the State compensation structure would make it difficult to attract the appropriate talent.
- In order to properly select investments and oversee the portfolio, the investment professionals would need to travel extensively to emerging market countries which include countries such as China, Russia, India and Turkey. Given the current overall restrictions on travel, we could not effectively internally manage such a portfolio.

- The Division would need to hire several traders to work on a 24 hour basis due to the time differences in all the markets. These traders would also need the ability and skills to trade the local currency as well as the equity and fixed income instruments. Additionally, these individuals would be required to work on virtually all State holidays since the international markets are open.
- The Division is attempting to replace the Trade Order Management System it currently utilizes as part of a custodian/systems search which is in process. Our current system would not adequately handle trading in diverse international markets.
- The Division would need to counsel with consultants and legal advisors to gain the required knowledge of all applicable emerging market laws and regulations.

Even with these incremental costs, these assets could likely be managed internally at a reduced cost to the pension fund relative to our existing external advisors. It would be necessary, however, to obtain assurance that these issues could be adequately addressed before proceeding to implement this recommendation.

Finally, assuming the issues discussed above could be addressed, we would suggest that only a portion of the portfolio be managed by internal staff. This would be a major undertaking for the Division, and we believe it would be prudent to initiate this effort as a "pilot program" and to evaluate our performance relative to the external advisors.

Sincerely,

William G. Clark

William G. Clark
Director

Cc: Mr. R. David Rousseau, Treasurer