

MINNESOTA
STATE
BOARD OF
INVESTMENT

DATE: January 8, 2004

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TO: The Honorable Tim Pawlenty
Members of the Minnesota Legislature

FROM: Howard J. Bicker, Executive Director

SUBJECT: External Money Manager Report Pursuant to Minnesota
Statutes Section 11A.04, clause (12)

Board Members:

Governor
Tim Pawlenty

State Auditor
Patricia Anderson

Secretary of State
Mary Kiffmeyer

Attorney General
Mike Hatch

Executive Director:

Howard J. Bicker

Minnesota Statutes, Section 11A.04, clause (12) requires the State Board of Investment (SBI) to report annually to the Governor and Legislature the cost and investment performance of external investment managers employed by the Board.

On June 30, 2003, the SBI utilized 23 domestic stock managers, 11 international stock managers and 8 bond managers for the retirement assets under its control. As a matter of policy, the SBI allocates approximately one third of domestic stock to active management, one third to semi-passive management and one third to passive management. As a matter of policy, the SBI allocates approximately two thirds of international stock assets to active management and approximately one third to passive management; and, approximately one half of all bonds to active management and one half to semi-passive management. The investment performance of each manager, as well as the fees paid to each, are reported in the charts on the following pages. This information is also included in the Board's annual report for FY03. Please note that the SBI terminated one bond manager in FY03.

Ten (10) firms in the Emerging Manager Program are included in the total number of domestic stock managers referenced above. This program is designed to seek out newer or younger firms with limited assets under management. As a group, the Emerging Managers account for less than five percent of the total domestic stock assets under the control of the SBI.

It is important to note that all performance data reported by the SBI is *net* of fees and transactions costs associated with the various portfolios. The SBI's FY 2003 Annual Report contains additional detail on manager performance.

60 Empire Drive
Suite 355
St. Paul, MN 55103
(651) 296-3328
FAX (651) 296-9572
E-mail:
minn.sbi@state.mn.us
www.sbi.state.mn.us

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Domestic Stock Managers

The SBI evaluates domestic stock manager returns against the performance of customized indices constructed to represent the managers' specific investment approaches. These custom indices are commonly referred to as "benchmark portfolios." The benchmark portfolios take into account the market forces that at times favorably or unfavorably impact certain investment styles. Thus, the benchmarks are more appropriate standards against which to judge stock manager performances than are broad market indices such as the Dow Jones Average or the Standard and Poor's 500. The aggregate domestic stock program is designed to outperform the Wilshire 5000 Investable, a custom index which adjusts the Wilshire 5000 for liquidity and investability constraints as well as restrictions specific to the SBI (currently tobacco) and is a quarterly buy/hold portfolio. The SBI believes that the Wilshire 5000 Investable is a more appropriate benchmark for a large institutional investor like the SBI.

As a group, the managers underperformed the broad market by 0.4 percentage point for the fiscal year. The performance of individual domestic common stock managers for FY 2003 was mixed. Two active managers outperformed their benchmarks, while seven underperformed. One semi-passive manager outperformed and two underperformed their benchmarks. The passive manager matched its benchmark. Two of ten emerging managers outperformed their benchmarks, while eight underperformed.

International Stock Managers

The SBI evaluates international stock managers against market indices published by Morgan Stanley Capital International (MSCI). Two indices are used: the index of Europe, Australasia and the Far East (EAFE-Free) and the Emerging Markets Free (EMF). As a group, the international stock managers underperformed a composite of the EAFE index and Emerging Markets index by 1.7 percentage points for the fiscal year. The six EAFE managers underperformed the index; one of four emerging markets managers outperformed EMF. The passive manager outperformed the EAFE index.

Bond Managers

The SBI evaluates the performance of its bond managers against the Lehman Brothers Aggregate bond index. Three of the five active managers met or exceeded the benchmark, while two underperformed. Two of the three semi-passive bond managers outperformed the index for the year and the third matched the index. As a group, the bond managers outperformed the broad bond market by 0.3 percentage point for the year.

Figure 16. Domestic Stock Manager Performance FY 2003

	Actual Return	Benchmark Return
Active Managers		
Alliance Capital Management	-0.7%	1.7%
Cohen Klingenstein & Marks	8.9	10.2
FLA Asset Management	-7.5	4.4
Franklin Portfolio Associates	-7.1	5.1
GeoCapital	10.6	14.3
Lincoln Capital Management	-2.0	4.2
New Amsterdam Partners	-0.1	0.1
Oppenheimer Capital	2.3	-1.2
UBS Global Asset Management	4.2	1.6
Semi-Passive Managers		
Barclays Global Investors	1.9	0.2
Franklin Portfolio Associates	-1.1	0.2
J.P. Morgan Investment Mgmt.	-0.4	0.2
Passive Manager		
Barclays Global Investors	0.8	0.8
Aggregate Stock Pool*	0.4	
Asset Class Target		
Wilshire 5000 Investable	0.8	

* Includes Emerging Manager Program, see below.

Figure 17. Emerging Manager Performance FY 2003

	Actual Return	Benchmark Return
Artemis Investment Management	-7.6%	-0.1%
Bay Isle Financial Corp	-9.7	-0.2
Earnest Partners	2.3	6.2
Holt-Smith & Yates Advisors	-5.7	-2.0
Next Century Growth Investors	-0.1	6.6
Peregrine Capital Management	-6.9	-1.3
Valenzuela Capital Partners	-9.1	-2.7
Voyageur Capital Management	-2.4	-0.3
Winslow Capital Management	4.6	2.1
Zevenbergen Capital	9.3	3.4

Figure 19. Bond Manager Performance FY 2003

	Actual Return	Benchmark Return
Active Managers		
American Express Asset Mgmt.	9.5%	10.4%
Deutsche Asset Mgmt.	11.3	10.4
Dodge & Cox Investment Mgmt.	12.7	10.4
Morgan Stanley Investment Mgmt.	8.2	10.4
Western Asset Mgmt.	13.1	10.4
Semi-Passive Managers		
BlackRock Financial Mgmt.	11.2	10.4
Goldman Sachs Asset Mgmt.	11.0	10.4
Lincoln Capital Mgmt.	10.4	10.4
Aggregate Bond Pool	10.7	10.4
Asset Class Target		
Lehman Aggregate	10.4	

Figure 21. International Manager Performance FY 2003

	Actual Return	Benchmark
Active Managers: Developed Markets		
American Express Asset Mgmt.	-9.3%	-6.5%
Britannic Capital Mgmt.	-7.5	-6.5
Invesco Global Asset Mgmt.	-8.9	-6.5
Marathon Asset Mgmt.*	-6.3	-2.4
T. Rowe Price International, Inc.	-8.8	-6.5
UBS Global Asset Mgmt.	-8.0	-6.5
Active Managers: Emerging Markets		
Alliance Capital Mgmt.	9.0	6.7
Capital International	5.3	6.7
Morgan Stanley Investment Mgmt.	4.6	6.7
Schroder Investment Mgmt. N.A.	4.1	6.7
Passive EAFE Manager		
State Street Global Advisors	-6.1	-6.5
Aggregate International Pool	-6.2	
Asset Class Target**	-5.4	

* Marathon's performance is measured against a custom benchmark since inception.

** The asset class target is comprised of the EAFE Free and Emerging Markets Free (EMF) indices. The weighting of each index fluctuates with changes in market capitalization.