State of Rhode Island and Providence Plantations
STATE INVESTMENT COMMISSION

Regular meeting February 22, 2006

A State Investment Commission ("SIC") meeting was held in Room 135, State House, Providence, Rhode Island on Wednesday, February 22, 2006. The Treasurer called the meeting to order at 9:05 a.m.

Membership Roll Call. Present were: Mr. Jeffrey Britt, Mr. George Welly, Designee of Ms. Rosemary Booth Gallogly, Ms. Marcia Reback, Mr. John Treat, and General Treasurer Paul J. Tavares. Mr. J. Michael Costello joined the meeting at 9:40 a.m. Also present were: Ms. Joan M. Caine, Deputy Treasurer for Finance, Mr. William G. Bensur of Wilshire Associates Incorporated, Consultant to the Commission, Jayne Donegan, Esq., of Brown Rudnick Berlack Israels, Legal Counsel to the Commission, Ms. Tara Blackburn of Pacific Corporate Group, Alternative Investments Consultant to the Commission, Mr. Frank Blaschka and Mr. Anthony Frammartino of The Townsend Group, Real Estate Consultant to the Commission and other members of the Treasurer's Staff.

Treasurer Tavares reported that Commission Member Dr. Robert McKenna has been seriously ill and hospitalized recently. He is now in therapy and recuperating at home but is unable to attend meetings. He will be celebrating his 75th birthday tomorrow. The Treasurer noted that the Separation of Powers legislation has not been passed and is still pending which is continuing to cause quorum problems.

State Investment Commission Minutes. Mr. Treat moved, Mr. Britt seconded and the following motion was passed unanimously. The following members voted in favor: Mr. Britt, Mr. Welly, Ms. Reback, Mr. Treat, and Treasurer Tavares. (Note: Mr. Costello was not present for this vote).

VOTED: To approve the Minutes of the December 7, 2005 Regular meeting and to approve and seal the Minutes of the December 7, 2005 Executive Session.

Proposed Investment in Charterhouse Capital Partners VIII, L.P. ("CCP VIII"). Ms. Tara Blackburn of Pacific Corporate Group ("PCG") gave a brief overview of CCP VIII. She noted that the Employees' Retirement System of Rhode Island ("ERSRI") is a limited partner in Charterhouse VII. She noted that Charterhouse is a European group heavily focused on large cap investing in the UK and France.

Mr. Geoffrey Arbuthnott, Partner, represented CCP VIII. He noted that CCP VIII seeks to raise €3.5 billion in total commitments and has set a hard cap of €4.0 billion. Mr. Arbuthnott stressed that Charterhouse has a distinctive philosophy whereby they concentrate on one fund at a time taking up to 4-5 years to fully invest. They have a strong, stable, experienced investment team with a good track record and are backers of incumbent management. Of twenty professionals, sixteen are based in London and four are based in Paris. The CCP VIII team has committed 1% to the fund.

Charterhouse intends to continue the investment strategy employed in its prior fund, which is to pursue large company buy-outs in Western Europe. They anticipate a relatively concentrated portfolio of ten to twelve investments. The fund would be classified as an international investment in the corporate finance category of ERSRI's sector target allocation.

Ms. Reback moved, Mr. Britt seconded and the following motion was passed unanimously. The following members voted in favor: Mr. Britt, Mr. Welly, Ms. Reback, Mr. Treat, and Treasurer Tavares. (Note: Mr. Costello was not present for this vote).

VOTED: To invest up to 15 million Euros in Charterhouse Capital Partners VIII, L.P., contingent upon satisfactory review and negotiation of investment and other legal documents.

Proposed Investment in Focus Ventures III, L.P. ("Focus III"). Ms. Blackburn gave a brief overview of Focus III noting that a commitment to this fund would be to the venture capital sub-sector. Focus III will invest exclusively in expansion and later-stage technology companies with a demonstrated revenue stream.

Mr. Kevin J. McQuillan, General Partner and Mr. Steven P. Bird, General Partner represented the fund. Mr. Bird noted that Focus III will target companies backed by top tier early stage firms. The two previous funds combined total $570 million in assets under management. They have produced an aggregate net IRR of 102% for the past eight years. Target fund size is $200 million with a cap of $250 million.

Focus III will invest in five sub-sectors: access equipment, consumer video, security, wireless technology, and next generation internet services. They actively identify and partner with technology companies through both its deep network of leading early-stage venture capital firms and the team's proprietary top-down company sourcing effort. They monitor and track up to 1,500 venture backed companies until they identify 300 companies as likely candidates for an investment. Once narrowed to 50 to100 target companies, Focus meets personally with management teams. Their proven selection process includes analyzing the tech sectors to determine the best opportunities, to monitor those companies and then to select the leaders for investment.

Mr. Treat moved, Mr. Welly seconded and the following motion was passed unanimously. The following members voted in favor: Mr. Britt, Mr. Costello, Mr. Welly, Ms. Reback, Mr. Treat, and Treasurer Tavares.

VOTED: To invest up to $15 million in Focus Ventures III, L.P., contingent upon satisfactory review and negotiation of investment and other legal documents.

Ms. Caine noted that approval process of alternative investments has been taking an enormous amount of the Commission's time. That combined with the approval process of the real estate investments has made it burdensome to the Commission. She and PCG have been working on streamlining the process to make it more efficient and to make Rhode Island an attractive investor.

Ms. Caine and Ms. Blackburn suggested the possibility that fund groups that already have an established relationship with ERSRI such as "re-ups" be waived from presenting before the Commission provided the fund meets certain performance guidelines. Any new relationships would still be required to come before the Commission. Ms. Caine expects to bring a proposal to streamline the approval process to the March meeting. Ms. Blackburn noted that many clients have moved to similar approval processes for long-standing relationships where the manager has been performing well to expedite the process of approval.

Treasurer Tavares explained to Commission members that in the previous administration alternative investments were presented to a sub-committee and then brought before the Commission for final approval. He stated that the Commission would not be relinquishing any control over approval of investments. He noted that alternative investments comprise only 7.5% of the portfolio and real estate investments comprise 5% of the portfolio and they have been taking an inordinate amount of the Commission's time.

The Townsend Group ("Townsend") - Amended Real Estate Investment Policy and Benchmark. Ms. Caine noted that the real estate target is 5% of the fund which today equates to approximately $285 million. Of the 5% target allocation, 2.5% has been temporarily allocated to international equities and 2.5% to domestic equities. Townsend is here today to present two proposals: 1) to amend the target allocation to the non core portfolio; and 2) to amend ERSRI's Investment Policy benchmark to include the NCREIF index. Mr. Frank Blaschka and Mr. Anthony Frammartino represented Townsend.

Amended Investment Policy. Mr. Blaschka noted that one of the critical risk management policies is the allocation of capital between the core and non-core portfolio. The core portfolio target is 65% and the non-core portfolio target is 35%. He noted that it is typical in the early periods of building a non-core portfolio to over-commit to the target allocation. As of September 30, 2005, ERSRI has made $115 million in commitments to these two sectors of which less than $10 million has actually been funded. The amended Policy makes only one change: it permits ERSRI to make an over-commitment of up to 25% of the target allocation to the non-core portfolio in order to facilitate portfolio construction and achieve a funded status that is closer to the permitted allocation under the Policy.

Mr. Blaschka explained that although the core portfolio still needs to be fully committed and funded ($170 million in commitments have been made as of September 30, 2005, but only $58 million has been funded), technically the portfolio is overallocated on a commitment basis to the non-core portfolio at the present time. Townsend surveyed its public pension fund clients and the vast majority permit over-commitment to the non-core sector. The amount of over-commitment ranges from 10% to 50%. Townsend proposes the amendment to permit the over-commitment to the non-core portfolio of up to 25% which falls within the mid-range of the practice of Townsend's pension and institutional client base.

Ms. Reback moved, Mr. Treat seconded and the following motion was passed unanimously. The following members voted in favor: Mr. Britt, Mr. Costello, Mr. Welly, Ms. Reback, Mr. Treat, and Treasurer Tavares.

VOTED: To amend the Employees' Retirement System of Rhode Island's real estate Investment Policy to permit up to a 25% over-commitment to the non-core portfolio.

Amended Policy Benchmark. Mr. Blaschka explained that up to this point, the formal ERSRI total plan level benchmark has not included any weight to real estate as the portfolio was in the early stages of construction. The real estate program's investment objective is to surpass the NCREIF Property Index ("NPI") plus 100 basis points, measured over rolling three-year periods. The active level of commitments since inception and increased funding towards the target allocation of 5% suggests that real estate no longer needs to be excluded from the total plan benchmark.

Townsend recommends that as of January 1, 2006, the overall ERSRI total plan level benchmark be revised to include the NPI at a weight of 5% of total plan assets, with the real estate portfolio benchmark lagged one quarter. In order to add the NPI, the prior benchmark weights to domestic and international equities will each be reduced by 2.5%. The lag is necessary to account for the extended timing requirements as they relate to reporting from the closed-end real estate funds.

Mr. Treat moved, Mr. Costello seconded and the following motion was passed unanimously. The following members voted in favor: Mr. Britt, Mr. Costello, Mr. Welly, Ms. Reback, Mr. Treat, and Treasurer Tavares.

VOTED: Effective January 1, 2006, to amend the Employees' Retirement System of Rhode Island's Investment Policy Benchmark to include the NCREIF Property Index ("NPI") at a weight of 5% with the NPI Benchmark lagged one quarter. Prior benchmark weights to domestic and international equities will simultaneously be reduced by 2.5%.

Third Quarter Review. Mr. Frammartino noted that to date ERSRI has committed $285 million to 12 commingled fund investments. Approximately $61 million remains to be committed to future commingled fund investments in the stable return and likely the enhanced return sectors. The investing of capital from prior commitments has picked up considerably with 23% of prior commitments having been invested as of the third quarter 2005.

He noted that the stable return investments outperformed the NPI for the third quarter by 110 basis points. The enhanced and high return investments are lagging due to the effects of the "j curve" whereby fees on committed capital mitigate distributions to ERSRI due to minimal invested capital and the early stages of the value-added process. When fully funded the portfolio will consist of the following property types: approximately 30% in office, 18% in industrial, 20% in apartments, 21% in retail, and 1% in hotels.

Gateway Eight Update. Ms. Caine reported that Fidelity Investments has entered into a lease dated January 19, 2006 with respect to the Gateway Eight building and she thanked Townsend for their help in securing Great Point Investors ("Great Point") as a property manager which was instrumental in the culmination of the bankruptcy process and execution of Fidelity's lease. Treasurer Tavares also thanked Ms. Caine for her hard work and diligence in this difficult matter.

Ms. Caine reported on some of the key lease terms and conditions. The lease will generate $2.04 million of revenue per year or approximately $170,000 per month. Fidelity has agreed to pay all the operating expenses and utilities, except for the ground lease. The cost of the ground lease is approximately $18,000 per month. The term is for three years with an option to renew for an additional three years. This equates to approximately $18 per square foot of office space.

Fidelity will also pay for some deferred maintanance repairs to the building such as fixing the cooling tower, cracks in the first floor slab, repair concrete, steel and the ventilation system in the 150-car parking garage. For this ERSRI will credit Fidelity up to $460,000 (approximately 3 months' rent). The repairs are expected to be completed by May 2006 and Fidelity plans to move into the building in June 2006.

Ms. Caine also noted that simultaneously with the lease negotiations, Great Point interviewed four real estate brokers to market/sell the building. They were: CB Richard Ellis, Cushman Wakefield, Keystone Realty and Meredith and Grew. CB Richard Ellis ("CBRE") was chosen as the real estate broker. CBRE has distributed a packet of information electronically to thousands of real estate funds and investment managers including ERSRI's own investment managers. Approximately sixty-eight of those entities have signed confidentiality agreements in order to receive a more comprehensive package of information on the building.

Mr. Blaschka noted that he was surprised at the level of interest in the building. He expects approximately one third of those entities to make an offer on the building which would greatly help in maximizing the value of the building. He also noted that Fidelity is an excellent tenant which will help in marketing the building.

<u>Securities Lending Program - State Street Corp. ("State Street")</u>. By way of history, Ms. Caine stated that in 1994-95 ERSRI had pulled out of the securities lending program. In 2000 Wilshire recommended issuance of a Request for Proposals ("RFP") for a new custodial bank. State Street was ultimately selected and they offered additional products and a new team. Wilshire then recommended that we would benefit from the fee structure if the securities lending program was re-established. She noted that the risk parameters of the securities lending program are much more stringent now and there is the opportunity to earn an additional $2 million per year by participating in the program.

Ms. Caine explained that there were two investment vehicles that the Commission could have invested in when the program was re-established in 1999. The more conservative option, "Quality A" investment pool was the one chosen for ERSRI. At this point, it makes sense to move the collateral investment option to the "Quality D" investment pool. Mr. Bensur noted that the major difference between the pools is the ability for Quality D to use securities with longer maturities and higher exposure to floating rate instruments.

Mr. Henry Disano, Vice President and Mr. Glenn Horner, Vice President represented State Street Securities Finance. Mr. Disano reported that in 2005, $2.5 million of revenue was generated for ERSRI in the securities lending program with a 75/25 split of revenue. Ms. Caine noted that State Street's custody fees had previously been over $1 million per year, but that with the new fee structure and the re-establishment of the securities lending program State Street's fees are now less than half that, closer to $300,000 per year.

Mr. Disano noted that State Street is the most experienced and largest securities lending agent in the world with $2.5 trillion in lendable assets. Currently $410 billion of assets are on loan in over 35 markets globally. State Street has 300 employees worldwide dedicated to securities lending. He noted that no investment in the cash collateral accounts has ever missed a payment and there have been no losses due to counterparty default in the history of the State Street program.

Mr. Horner, who heads up the risk management team noted that the average historic return relative to Fed Funds since 1998 was 31 basis point for Quality D and 23 basis points for Quality A. Quality D has outperformed Quality A on a spread return basis in 95 of the last 96 months. Quality D has never had a negative spread to the risk free rate during this period, as compared to 5 occurrences for Quality A. State Street estimates that ERSRI would have earned an additional $2.2 million since 2001 if it had been invested in Quality D.

Mr. Britt moved, Mr. Costello seconded and the following motion was passed unanimously. The following members voted in favor: Mr. Britt, Mr. Costello, Mr. Welly, Ms. Reback, Mr. Treat, and Treasurer Tavares.

VOTED: To approve State Street's "Quality D" collateral pool as the investment vehicle for the Employees' Retirement System of Rhode Island's securities lending collateral.

Investment Manager Review - MacKay Shields ("MacKay"). Ms. Caine reported that MacKay's lead portfolio manager for the high yield portfolio, Mr. Donald Morgan, has resigned from the firm which causes concern going forward despite strong historical performance. Therefore, MacKay was invited today to explain how the firm will handle his departure. Mr. Bensur gave a brief overview of MacKay Shields which was retained in 2002 to provide a long-term strategic exposure to the high yield segment of the US fixed income market. Market value of the portfolio as of 12-31-05 was $127 million. MacKay comprises approximately 7.5% of the fixed income composite and approximately 1.7% of the total fund composite.

Mr. Kirk Kashevaroff, Director of Institutional Business Development and Mr. Mathew Philo, Senior Managing Director and Co-Head of Fixed Income, High Yield Division represented MacKay. Mr. Kashevaroff explained that Matt Philo and Don Morgan had taken over the high yield portfolios in January 2000 from Steve Tannenbaum upon his departure from the firm. So Mr. Morgan's departure had not dramatically affected the portfolio as Mr. Philo is completely comfortable with continuing to manage the portfolio. Mr. Kashevaroff explained that Mr. Morgan had resigned to start his own firm and that a senior analyst had also resigned. He noted that an additional two senior analysts will be added to the MacKay team.

Mr. Philo stated that there will be no changes in the management of the portfolio because of Mr. Morgan's departure. He noted that Mr. Morgan's non-compete agreement will most likely expire at the end of 2006. After lengthy questioning, Mr. Philo indicated he had no intentions to leave MacKay, but that he could not guarantee his tenure at MacKay.

Legal Counsel Report. Ms. Donegan explained a need to ratify a previous vote taken by the Commission regarding an investment in Nordic Capital Fund VI, L.P. to have the investment in Euros rather than dollars.

Ms. Reback moved, Mr. Britt seconded and the following motion was passed unanimously. The following members voted in favor: Mr. Britt, Mr. Costello, Mr. Welly, Ms. Reback, Mr. Treat, and Treasurer Tavares.

VOTED: To ratify approve and confirm the execution by the Treasurer of legal documents subscribing to an investment of up to 15 million Euros in Nordic Capital Fund VI, L.P.

Treasurer's Report. Treasurer Tavares noted that he and Ms. Caine have recently met with Wasatch Advisors, Inc. ("Wasatch") because of performance concerns. Ms. Caine noted that Wasatch has returned 21% over the last three years, but that return is approximately 200 basis points behind its benchmark. She mentioned concern with Wasatch's rapid growth. When Wasatch was hired in 2002, it had approximately $1 billion of assets under management and has now nearly tripled in size. Mr. Bensur noted that Wasatch has good people, good products, a clear philosophy and great process. However, their rapid growth has taken its toll on implementation of their strategy. Ms. Caine explained performance over the last few years had been adversely affected by lack of coverage and exposure to the energy industry and a few concentrated portfolio companies' involvement in fraudulent accounting activity.

Ms. Caine stated that Mr. Bensur will present his Manager Continuation Policy at the March meeting of the Commission which will include recommendations regarding all managers.

Deputy Treasurer for Finance Report. Ms. Caine distributed an article and commended the Commission members for their part in the fund's 9.4% return for 2005, beating the benchmark's 7.8% return. She noted that US equities were up 6.4%, international equities were up 16.4%, fixed income was up 3.2%, while private equity generated an IRR of 41%. On a total return basis, private equity was up 35.6%.

Ms. Caine also noted that the fund's performance compared favorably to other public pension funds, foundations, and endowments as measured by the Trust Universe Comparison Survey ("TUCS"). According to TUCS, foundations and endowments returned an average of 8.7%, corporate funds returned 7.6%, and public funds returned 7.5%, all well below ERSRI's 9.4%.

Treasurer Tavares thanked the Commission for their indulgence in such a full meeting as January's meeting had been canceled.

Mr. Costello moved, Ms. Reback seconded and the following motion was passed unanimously. The following members voted in favor: Mr. Britt, Mr. Costello, Mr. Welly, Ms. Reback, Mr. Treat, and Treasurer Tavares.

VOTED: To adjourn the meeting.

There being no further business, the meeting was adjourned at 11:40 a.m.

Respectfully submitted,

Paul J. Tavares
General Treasurer