State of Rhode Island and Providence Plantations
STATE INVESTMENT COMMISSION

Regular Meeting September 27, 2006

A State Investment Commission ("SIC") meeting was held in Room 135, State House, Providence, Rhode Island on Wednesday, September 27, 2006. The Treasurer called the meeting to order at 9:05 a.m.

Membership Roll Call. Present were: Mr. Jeffrey Britt, Mr. Michael Costello, Ms. Rosemary Booth Gallogly, Mr. John Treat, and General Treasurer Paul J. Tavares. Also present were: Ms. Joan M. Caine, Deputy Treasurer for Finance, Jayne Donegan, Esq., of Brown Rudnick Berlack Israels, Legal Counsel to the Commission, Mr. William Bensur of Wilshire Associates Incorporated, General Consultant to the Commission, Mr. Christopher Bower, Ms. Kara King, Mr. Tom Keck, and Mr. Mark Oemcke of Pacific Corporate Group, Alternative Investments Consultant to the Commission, and other members of the Treasurer's Staff. Ms. Reback arrived at 9:06 a.m. and Dr. Robert McKenna was absent.

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

VOTED: To approve the Minutes of the August 30, 2006 regular meeting.

Pacific Corporate Group ("PCG") Organizational Update. Ms. Caine introduced Mr. Christopher Bower, Founder and Chief Executive Officer of PCG, Ms. Kara King, Head of Monitoring & Reporting, Mr. Tom Keck, Head of Research and Mr. Mark Oemcke, Chief Operating Officer. Ms. Caine noted that the relationship with PCG has been a long-standing and profitable one. Although the private equity sector of the portfolio is only 7.5%, it has delivered strong returns of over 16% annualized since inception consistently beating the benchmark. Ms. Caine noted that recent senior staff departures have caused concern as it is not the first time PCG has experienced sudden departures. The four individuals who recently resigned are: president, Monte Brem and managing directors Tara Blackburn, Stephen Moseley and Michael Russell.

Mr. Bower explained that PCG has been investing on behalf of the Employees' Retirement System of RI ("ERSRI") since 1995. The firm was started in 1979 and has grown approximately 50% over the last year to nearly 60 people with 11 managing directors. Recent hires include Michelle Davidson and David Scopelliti who have backgrounds in private equity. He explained that private equity is a long-term asset class. He stressed that PCG still has a large team, a deep bench and institutionalized investment processes. Although the departures are unfortunate, Mr. Bower noted that PCG is well situated to continue to implement its proven and successful investment strategy which has delivered outstanding returns for its clients.

Mr. Bower explained that PCG Asset Management oversees more than $15 billion of private equity commitments through a combination of discretionary management and advisory arrangements and PCG Capital Partners makes direct investments in operating companies through the PCG Corporate Partners Fund and co-investment funds. The four departing individuals had approached Mr. Bower to renegotiate their contracts and also wanted some changes in governance and operations. Those changes were taken under consideration and agreed to and

PCG researched comparable compensation packages. After further negotiations, the compensation issues were unable to be resolved.

Mr. Bower reported that CalPERS has been a client for 18 years and PCG has returned an IRR of 18% to them; the State of Oregon has been a client for 15 years and PCG returned 17.5%, New York City has been a client for 10 years and PCG has returned 13%. PCG is one of the largest, oldest and most successful firms in the business. PCG has changed over the years, institutionalized, rallied and met obligations with no change in performance despite some departures.

Mr. Keck gave an overview of the background and highlighted the new structure of PCG. The parent company is PCG Holdings with two subsidiaries: PCG Asset Management and PCG Capital Partners. The role of president of PCG Asset Management has been replaced by a Management Committee. Client service responsibilities of Tara Blackburn have been allocated to Michelle Davidson and those of Michael Russell have initially been assumed by Michelle Davidson and Kara King. Under the old structure, PCG Holdings owned 70% of the assets with senior employees having a contingent 30% interest. Under the new structure, PCG Holdings owns 50% with the PCG asset management team having 50% ownership rights. Full ownership rights now vest over five years. However, the holding company, PCG Holdings, has only one member, Chris Bower.

Mr. Bower noted that PCG asset management clients are assessing the impact of the recent departures, and several clients are looking to the PCG's larger clients to assist in that evaluation. CalPERS is currently conducting due diligence and will announce their determination within the next few weeks. So far no client has taken any negative action.

Treasurer Tavares thanked Mr. Bower and asked that he continue to keep the Treasurer's office apprised of the situation going forward.

Treasurer Tavares explained that ERSRI has no financial exposure to be concerned with, and the technical reporting has remained entirely intact with no changes. He also noted that the research and due diligence teams are still completely intact. He feels there is no immediate risk to the pension fund. Ms. Caine explained that she contacted other state plans in Oregon, Illinois and Colorado and while they agree with Ms. Caine that there is no reason to take any immediate action, some states will be pursuing a request for proposal process. She stated that there is a very limited group of consultants that offer what ERSRI has now which is a non-discretionary relationship. Treasurer Tavares indicated that staff would continue to monitor the situation.

<u>Coller International Partners V, L.P. ("Coller V")</u>. Ms. King gave a brief overview of Coller V noting that it is a "re-up" as ERSRI had invested $15 million in Coller IV in 2002. This fund is the only secondary relationship held in the portfolio and it had an IRR of 26.4% as of 6/30/06. Mr. Keck noted that Coller is one of the few secondary funds that PCG is recommending.

Mr. Frank Morgan, Partner represented Coller V. He noted that Coller has been in business for 16 years with four funds and has produced consistent top-quartile returns for all funds. Coller has the largest team of investment professionals dedicated to secondaries which is its exclusive focus and is an acknowledged leader in direct secondaries as well. He explained that Fund V will acquire a diversified portfolio of interests in established private equity funds from institutional holders seeking liquidity through secondary market transactions. The fund will also pursue direct private equity investments into portfolios of corporate assets not held in traditional fund structures.

He noted that Coller V will be diversified by manager, investment strategy, vintage year and industry sector. Target fund size is $3 billion with a hard cap of $3.75 billion and will focus on investments in Europe and the US. The net IRR's of Coller's previous four funds are as follows: Coller I - 23%; Coller II - 25%, Coller III - 17%, and Coller IV - 30%. Coller's strategy includes creating investment opportunities, staying flexible and disciplined and anticipating the market.

Note: Ms. Reback left the meeting at 10:18 a.m.

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

VOTED: To invest up to $15 million in Coller International Partners V, L.P. contingent upon satisfactory review and negotiation of investment and other legal documents.

Granite Global Ventures III, L.P. ("Granite III"). Ms. King gave a brief overview of Granite III noting it is a "re-up" as ERSRI invested $15 million in Granite Global II in 2004. Granite III has a late-stage growth focus and along with ERSRI's investment in Focus Ventures III are the only two relationships that give exposure to this category. Mr. Keck noted that Granite has a great reputation in the market and is able to get into the most attractive deals. Granite III is being formed to make investments primarily in expansion stage information technology companies with select healthcare investments split equally between the US and China. Granite III will continue to focus on mid and late stage companies with proven technology and products, revenue visibility, established management teams and a clear path to liquidity.

Mr. Hany Nada, Founding Managing Director, Mr. Stephen Hyndman, CFO and Mr. Jack Troy of Troy Investments (Placement Agent) represented Granite III. Mr. Nada noted that Granite Fund I has returned a net IRR of 21%. Fund II has had one exit and expects several more in the near future. Granite III will leverage its networks and presence in the US and China to assist its portfolio companies in extending their reach into the global markets. It will introduce strategic partners and help businesses to expand operations, develop new customer relationships and take advantage of lower cost structures through outsourced business processes.

Granite III will build a portfolio of approximately 30 to 35 companies, investing in six to ten new companies per year. They expect to invest $3 to $12 million per investment and seek a board seat on the majority of its investments. Target fund size is $350 million with a hard-cap of $400 million.

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

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

Manager Review - Shenkman Capital Management, Inc. ("Shenkman"). Ms. Kim Hekking, Senior Vice President and Mr. Mark Shenkman, President represented Shenkman. Mr. Shenkman noted that the firm was hired four years ago when default rates in high yield bonds had hit 11% per year. Shenkman has had no departures, no changes in ownership or management and has $10.3 billion of assets under management. Shenkman employs a bottom-up, fundamental credit analysis with intensive credit research utilizing internally developed proprietary tools.

Mr. Shenkman noted that bonds under $80 and rated CCC have led performance recently and the same situation happened in 2003 and 2004. Shenkman outperformed in 2005 when CCC bonds did not do well. Shenkman will consistently underperform when CCC bonds outperform because Shenkman is a traditional high yield manager with a focus on higher quality NIG bonds.

Mr. Shenkman explained that Shenkman believes the credit cycle is at its peak and turning. He expects a declining GDP in 2007, a tightening of credit standards and concerns about credit problems and higher standards going forward. He noted the positive high yield market drivers: a strong US economy, default rates have been low, demand has been very strong and now interest rates are in their favor with 10 year treasuries down. Mr. Shenkman noted that Shenkman has a better chance now to outperform because their average price has come in line with the index. On a risk adjusted basis Shenkman has done well.

Mr. Shenkman stated that in 2002 the portfolio value was $95 million and now the portfolio value is $126.8 million. During that four year period, Shenkman has generated interest income, dividends and accrued income of $36.2 million. The high yield markets have had 147 defaults and Shenkman has had none.

Mr. Bensur noted that Shenkman had been hired four years ago along with MacKay Shields as they had complimentary styles. He stated that the portfolio trails the benchmark by 2.54% on a three-year basis and by 5.14% since inception. Mr. Shenkman asked the Commission to consider the fact that they've only had one part of the credit cycle, only expansion. Shenkman believes 2007 will bring a different credit cycle which favors their style.

Wilshire Associates Incorporated - Manager Continuation Policy Analysis. Mr. Bensur briefly reviewed the investment managers noting that it is Wilshire's recommendation to continue to retain all of the following four US Equity managers for their current assignments: NorthPointe Capital, PIMCO StocksPlus, State Street Global Advisors and Wellington Management Co. Wilshire recommends terminating Wasatch Advisors, Inc. because of poor performance. He noted that Wasatch has been an asset gatherer in the small cap growth space which has increased their capitalization and hurt their performance.

Wilshire also recommends continuing to retain The Boston Company Asset Management, Goldman Sachs Asset Management and Mondrian Investment Partners, Ltd. For their Non-US Equity assignments. Of the five fixed income managers, Wilshire recommends continuing to retain the following for their current assignments: Brown Brothers Harriman & Co., Fidelity Management Trust Co., and Taplin, Canida & Habacht, Inc. With regard to MacKay Shields, LLC, it is Wilshire's recommendation to continue to monitor them regarding their personnel developments. With regard to Shenkman Capital Management, it is Wilshire's recommendation to continue to monitor their performance as they are officially on the "Watch List" and Wilshire believes that it is the wrong time to make a change at this point.

Mr. Bensur also recommended maintaining the current public market target exposures to US Equity (42.5%), non-US equity (20.0%) and fixed income (25.0%). He noted that given the recent outperformance of small stocks, Wilshire is recommending that the investment structure adjust the large stock to small stock ratio from 70%-30% to 75%-25% to reflect market profile and opportunity. Wilshire also recommends utilizing the passive/index exposure on a temporary basis (45% to 50%) to manage this transition and to eventually expand the enhanced index/portable alpha exposure from 15% to 20%.

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

VOTED: To accept Wilshire Associates' recommendations in the Manager Continuation Policy Analysis Report presented at the September 27, 2006 SIC meeting to terminate Wasatch Advisors Inc. effective immediately based on poor performance and to invest the assets in a State Street Global Advisors large cap US equity index to be determined by staff and consultant.

State Street Global Markets ("SSgM")- Portfolio Solutions. Ms. Caine stated that SSgM is here today to follow up on a former presentation she gave the Commission regarding services SSgM provides that we are not utilizing at this time but that may be beneficial to the plan. SSgM provides an overlay service which would help staff to rebalance the portfolio on a monthly basis back to target more efficiently. SSgM could also potentially equitize some of the residual cash which would add some incremental value - estimated between 10 to 20 basis points.

Ms. Lisa Tyrrell, Vice President of State Street Bank & Trust Co. introduced Mr. Ross McLellan, Managing Director of SSgM. Mr. McLellan noted the first service SSgM provides is a strategic rebalancing program. He stated that asset allocation variances occur with large plans and the cost of physical trading can be expensive. Derivatives can be used to rebalance assets and plans are becoming more comfortable using them. Physical trading costs for US large cap equity are 20 basis points per transaction and using futures trading costs would be 2 basis points. In the US small cap equity space the savings would be over 68 basis points per transaction.

Strategic rebalancing would include setting up a dedicated account with the custodian for this purpose. This would eliminate staff from having to go to over-allocated managers and take money away for the purpose of giving it to an under-allocated manager. For larger clients like ERSRI, the potential benefit is the savings on transaction costs over a long period of time and a more streamlined process.

Mr. McLellan stated the second service SSgM offers is a cash equitization product that essentially sweeps the active investment managers' cash and equitizes it. He stated that most managers keep about a 3% cash balance so for an S&P manager over the last five years approximately 27 basis points (after fees) could be picked up by being in a cash equitization program. He noted that the less cash on hand, there is less potential for upside and downside returns.

The third service SSgM offers is a liquidity management program. Mr. McLellan noted that pension plans have cash flow needs for normal operations such as paying benefits, fees, private equity capital calls, etc. and that money must come from the investment managers. There are transaction costs incurred when raising cash which can be a drag on performance. SSgM can utilize unrivaled liquidity pools to cross assets and equitize until cash is needed and thereby eliminate many transaction and commission costs. The client determines which managers to take assets from.

Treasurer Tavares and Ms. Caine noted that ERSRI does experience cash flow problems on a monthly basis anywhere from $18 to $28 million. The Treasurer explained he wanted the SIC to be aware that there are vehicles and tools in the marketplace designed to streamline some of these processes. He asked Ms. Caine to evaluate the need for these services and report back to the Commission.

General Treasurer's Report. The Treasurer announced that as of 9/22/06 the CollegeBound*fund* has over $7 billion of assets. There are 475,000 accounts nationally and RI has 16,421 accounts. The value of the RI portfolio is $178 million. Rhode Island has also been ranked as the top performer in the nation for the third year in a row by savingforcollege.com.

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

VOTED: To adjourn the meeting.

There being no further business, the meeting was adjourned at 11:50 a.m.

Respectfully submitted,

Paul J. Tavares
General Treasurer