

**State of Rhode Island and Providence Plantations
STATE INVESTMENT COMMISSION**

Regular Meeting February 28, 2007

A State Investment Commission (SIC) meeting was held in Room 135, State House, Providence, Rhode Island on Wednesday, February 28, 2007. The Treasurer called the meeting to order at 9:05 a.m.

Membership Roll Call. Present were: Mr. Michael Costello, Ms. Rosemary Booth Gallogly, Mr. Robert Giudici, Dr. Robert McKenna, Mr. Andrew Reilly, Mr. John Treat, and General Treasurer Frank T. Caprio. Also present were: Mr. Kenneth E. Goodreau, Deputy General Treasurer for Finance; Mr. William Bensus, of Wilshire Associates Incorporated, General Consultant to the Commission; and other members of the Treasurer's staff. Ms. Marcia Reback was absent.

State Investment Commission Minutes. Mr. Costello moved, Dr. McKenna seconded and the following motion was passed unanimously. The following members voted in favor: Ms. Gallogly, Mr. Giudici, Mr. Reilly, Mr. Treat, and Treasurer Caprio.

VOTED: To approve the Minutes of the January 24, 2007 regular meeting.

Green Equity Investors V, L.P. (GEI V). Treasurer Caprio announced that a mistake had been made in the January SIC meeting in terms of the amount approved for investment in Green Equity Partners Fund V L.P. (GEP). He stated that the members had voted to approve \$15 million, and that the correct amount of recommended investment is \$20 million. Treasurer Caprio explained that the discrepancy stemmed from a transition between Treasury administrations from the one under former Treasurer Paul Tavares to the present, and from further review with PCG and other consultants. Treasurer Caprio therefore recommended increased investment from the amount of \$15 million to \$20 million in GEP.

Dr. McKenna moved, Mr. Costello seconded, and the following motion was passed unanimously. The following members voted in favor: Ms. Gallogly, Mr. Giudici, Dr. McKenna, Mr. Reilly, Mr. Treat, and Treasurer Caprio.

VOTED: To invest up to \$20 million in GEP Fund V, L. P., contingent upon satisfactory review and negotiation of investment and other legal documents.

Short Term Investments – BankRI. Treasurer Caprio announced the interest of BankRI to become one of the State of Rhode Island's short term investment vendors. Treasurer Caprio deferred to Mr. Vincent Izzo, Acting Cash Manager, who stated that BankRI has met all qualifying criteria to be added to the list of vendors. He explained that the State of Rhode Island typically has 11-12 active managers, but currently has 11 total managers of whom only eight are active. Treasurer Caprio asked for questions, and

there being none, referred the members to materials distributed on BankRI. Treasurer Caprio then recommended that BankRI be added to the list of active managers.

Dr. McKenna moved, Mr. Treat seconded, and the following motion was passed unanimously. The following members voted in favor: Ms. Gallogly, Mr. Giudici, Mr. Reilly, Mr. Treat, and Treasurer Caprio. Treasurer Caprio noted for the record that Mr. Costello removed himself from this vote.

VOTED: To add BankRI as an active manager to the list of vendors for short term investments.

Wilshire Associates Incorporated – Capital Market Review. Mr. Bensus summarized the three items on his agenda for presentation: capital market review, year-end performance summary, and management continuation policy review. Mr. Bensus began with the capital markets update and noted the previous day of volatility, specifically in reference to China and other emerging markets. He stated that the report was prepared two days prior and therefore the data would not reflect the latest fluctuations.

Mr. Bensus began his overview by stating that in general fundamentals remained in place despite fluctuations to indicate a market that is reasonably healthy, with company earnings that are in line with and above expectations and consumer confidence remaining largely in tact. Mr. Bensus observed that the housing markets are flattening but there remains reasonable expectation of some revaluation.

Mr. Bensus stated that while Chinese markets were the catalyst for recent market fluctuations, these fluctuations are likely part of a process of self-correction inherent in the evolutionary nature of an economy that has migrated over the last one hundred years from foundations of agriculture to manufacturing to service, with business cycles that are less dramatic and less frequent. Mr. Bensus observed that overall markets have seen solid expansion since 2002, and in that context, the previous day's losses (around 3.5%, following an 8-9% initial loss and 4% recovery) is most likely a normal revaluation of the risk profile of the markets.

Mr. Bensus stated that U.S. markets continue to be encouraged by companies' profitability. He observed that the big surprise in U.S. equities is the continued strength of small cap stocks, which remain ahead of large cap. Mr. Bensus stated that U.S. markets are forecasting modest economic growth overall.

Mr. Bensus stated that international markets remain attractive despite recent losses. Non-U.S. equities continue to outperform U.S. equities as they have for the past 5-6 years, driven by emerging markets that have pursued better economic and political policies, in addition to having commodities-based economies and relatively inexpensive yet educated workforces that are attractive to foreign investors.

In terms of fixed income markets, Mr. Bensus stated that there continues to be an unusual situation of an inverted yield curve combined with tight high yield spreads to Treasuries, which sends mixed signals to investors. Mr. Bensus explained that inverted yield curves typically forecast economic recession, while tight high yield spreads typically indicate economic strength.

Mr. Bensus reiterated the long-term strategy of RIIERS investments, and that going forward, fluctuations in the market are to be expected within the context of a long-term strategy. Mr. Bensus stated that he believes RIIERS investments are very well-structured for this long-term purpose, requiring little reaction on volatile market days such as the previous one.

Wilshire Associates Incorporated – Year-End Summary. Mr. Bensus introduced a comparison of RIIERS investments to peer funds, in terms of performance and asset allocation. Mr. Bensus stated that RIIERS investment allocations are roughly on par with peer funds in terms of U.S. equities (43% of fund) and alternative investments (6%), above average in terms of non-U.S. equities (24%), and slightly below average in terms of fixed income (23%).

Mr. Bensus summarized the total fund performance over one-, three-, and five-year bases: one-year (2006) saw 15% returns, which were slightly below policy. Three-year returns saw strong returns of 12.4% and a ranking in the 29th percentile (higher than 70% of RIIERS peer funds). Five-year returns were likewise strong with 9.8% returns and a ranking in the 20th percentile (higher than 80% of peer funds).

Mr. Costello inquired as to how securities lending and other revenues are accounted for in these figures. Mr. Bensus replied that he believes securities revenues come into the system and are accounted for incrementally on a total fund basis.

Treasurer Caprio asked Mr. Bensus to describe the difference between actual and policy performance. Mr. Bensus explained that policy benchmarks are derived from calculations related to target asset allocations and past performance numbers. Mr. Bensus explained that drift is a large factor contributing to differences between target and actual performance, such as the 4% that RIIERS invests (24% total) above its policy target of 20% asset allocation in non-U.S. equities, which yielded positive returns for the fund. Another contributing factor is the mix of both active and passive alternative investments employed by the fund.

Mr. Giudici expressed concern as to the capacity for the RIIERS fund to react to market changes, and inquired as to whether there are formalized guidelines in place, and whether they are monitored on an ongoing basis. Mr. Bensus answered affirmatively on both counts. He further stated that he believes the fund is well-structured to weather volatility, having a central anchor of fixed income along with more active investments that will serve the fund well in the long term. Treasurer Caprio requested that Mr. Giudici receive a copy of the fund's investment policy.

Mr. Bensus moved on to the individual performance analyses of each of the three sectors comprising RIIERS fund investments: U.S. Equities, non-U.S. equities, and fixed income. Mr. Bensus cited strong U.S. equity performance in both short (one-year) and long (seven-year) terms as evidence of the efficacy of the fund's structure. Mr. Bensus moved to non-U.S. equities, in which Mr. Bensus pointed to a disappointing period during May-June 2006 when the markets' risk preference shifted away from emerging markets and the fund netted a 1-2% loss; the markets flatlined until September before rising again sharply in the fourth quarter. Mr. Bensus said that while this struggle was disappointing it was not uncommon, and he believed the general fund structure was sound. Mr. Bensus pointed to solid returns over time: RIIERS investments saw returns in the top quartile over one- and three-year periods, and missed the top quartile by roughly 2% over five years. Mr. Bensus finally moved to fixed income investments, citing again their importance as an anchor for the fund, with returns well in line with expectation over the long term.

Ms. Gallogly inquired if there is anything the fund can do in terms of structure, specifically in relation to emerging markets and other risks, to better guard against market volatility. Mr. Bensus replied that there are limitations in place for both cash allocation and investment benchmarks that prevent investment managers from being overly reactive to market changes, and that over time the structure has proven sound.

Treasurer Caprio thanked Mr. Bensus for his review and introduced the management continuation policy overview, stating that it is performed every six months (in June and December) by the SIC.

Wilshire Associates Incorporated – Management Continuation Policy Overview. Mr. Bensus gave a brief history of the policy, which was implemented in January 2000, and used as one tool to evaluate investment managers. He stated that Wilshire utilizes a three-year trailing basis for evaluation, and that managers may be terminated and/or replaced when it is determined that their skill levels have dropped.

In terms of non-U.S. equity managers, Mr. Bensus commented that Boston Company has struggled somewhat in their performance but that he believes the firm is solid and worth retaining.

Mr. Bensus recommended termination of Shenkman Capital Management (Shenkman), which has shown disappointing performance. Mr. Bensus attributed this poor performance to, among other reasons, the fact that Shenkman has quadrupled its assets and is unsuccessfully applying its strategies over this greatly increased asset base. Mr. Bensus stated that while it is somewhat expensive to RIIERS to change managers, he believes it a prudent move for the fund to terminate its relationship with Shenkman.

Mr. Costello questioned Wilshire's strategy in terms of high yield investments and long term returns, stating that the decision to terminate a high yield investor such as Shenkman indicates a major shift in asset allocation in terms of long-range perspective. Mr. Costello further stated that he would like Mr. Bensus to clarify whether this is indeed

a long-term decision, or something more temporary. Mr. Bensur replied that Wilshire prefers high yield for solid returns over time, and that the issue would be revisited and/or qualifiers could be established for reevaluation. Mr. Bensur added that he believes a temporary reduction of risk exposure is most prudent for the fund until the credit environment returns to more normal conditions.

Treasurer Caprio interjected that the fund has the option to redeploy the cash from Shenkman to its other existing managers, both high yield and fixed income, in addition to using it for day-to-day cash operations, and this has been part of the internal staff discussions with Wilshire.

Mr. Costello inquired whether the fund would consider allocating more of this capital to high yield investors. Treasurer Caprio confirmed that as a possibility, and added that the reduction from two high-yield managers to one reflects an earlier composite of investment managers in the fund, which was originally structured with only one high-yield manager and added a second more recently.

There was some discussion of the long process of adding new managers to the fund, and the possibility of allocating more capital to existing managers in the high yield sector rather than selecting new managers and forging new relationships.

Mr. Bensur moved to discuss the performance of other managers in the fund, which he characterized as in line with benchmarks with the exception of Wellington Management Company (Wellington), which has shown somewhat disappointing returns. Mr. Bensur explained that the firm has reduced its risk exposures resulting in poor relative performance, but that he believes the firm remains sound and is not cause for concern.

Treasurer Caprio thanked Mr. Bensur for his report. There being no questions from the members, Treasurer Caprio then entertained a motion incorporating the recommendations of Wilshire, and pursuant to management continuation policy, that the SIC terminate the RIIERS fund's investment relationship with Shenkman Capital Management, and to instruct staff and consultants to liquidate holdings at the lowest possible transaction cost and without market disruption over the course of the next 45 days as necessary, and then to utilize the proceeds for daily cash needs of the fund and to redeploy excess cash to the fixed income investment structure.

Mr. Costello moved, Mr. Treat seconded, and the following motion passed unanimously. The following members voted in favor: Ms. Gallogly, Mr. Giudici, Dr. McKenna, Mr. Reilly, and Treasurer Caprio.

VOTED: To terminate the relationship with Shenkman Capital Management, removing them from the RIIERS fund investment manager list, to utilize proceeds for daily fund cash needs, and to redeploy excess cash to existing fixed income investment structure.

Legal Counsel Report. Ms. Donegan was not present for the meeting and there was no legal counsel report this month. Treasurer Caprio directed the SIC to await the report for the next meeting in March, and introduced Deputy Treasurer Goodreau.

Deputy Treasurer for Finance Report. Mr. Goodreau thanked the council, and stated that the termination of Shenkman is indication of the top to bottom review that the office of Treasurer is in the initial stages of conducting. Mr. Goodreau further stated that he considered the decision a matter of policy, and that the Treasury staff is thoroughly investigating whether any other changes should be undertaken.

Treasurer's Report. Treasurer Caprio thanked Mr. Goodreau for his comments. He announced the creation of an SIC subcommittee for issues of audit and governance, featuring Mr. Reilly and Mr. Giudici in addition to himself as the three initial members, with the possibility of adding more. Treasurer Caprio extended an open invitation to interested members.

Treasurer Caprio made brief comments about the previous day's unusual market fluctuations, stating that they will be watched closely. He further announced that State Street consultants are providing daily numbers, and that the RIIERS fund netted losses of only slightly more than 1% in the downturn. He noted that this minimal loss is indication of the successful diversification and asset allocation of the fund.

Finally, there being no questions from the members and no new business, Treasurer Caprio welcomed the two new members of the SIC, Mr. Giudici and Mr. Reilly, as well as Mr. Treat, who was not present at the previous meeting.

Mr. Reilly moved, Dr. McKenna seconded, and the following motion was passed unanimously. The following members voted in favor: Mr. Costello, Ms. Gallogly, Mr. Giudici, Mr. Treat, and Treasurer Caprio.

VOTED: To adjourn the meeting.

There being no further business, the meeting was adjourned at 10:20 a.m.

Respectfully submitted,

Frank T. Caprio
General Treasurer