

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

Regular Meeting June 27, 2007

A State Investment Commission (SIC) meeting was held in Room 135, State House, Providence, Rhode Island on Wednesday, June 27, 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 Gaudreau, Ms. Marcia Reback, Mr. Andrew Reilly, Mr. John Treat, and General Treasurer Frank T. Caprio. Mr. Robert Giudici and Dr. Robert McKenna were absent. Also present were: Mr. Kenneth E. Goodreau, Deputy General Treasurer for Finance; Mr. Brian Gallogly, Esq., of Brown Rudnick Berlack Israels, Legal Counsel to the Commission; Ms. Felicia Bennett, of Wilshire Associates Incorporated, General Consultant to the Commission; Ms. Lisa Tyrrell and Ms. Lara Callahan of State Street Corporation; Ms. Michelle Davidson, of Pacific Corporate Group (PCG), Alternative Investments Consultants to the Commission; and other members of the Treasurer's staff.

State Investment Commission Minutes. Treasurer Caprio noted the omission of Mr. Treat's name from the list of members present at the May 30, 2007 meeting. With this correction noted, the Treasurer entertained a motion for approval of the minutes. Mr. Reilly moved, Mr. Treat seconded and the following motion was passed unanimously. The following members voted in favor: Ms. Gallogly, Mr. Gaudreau, Mr. Reilly, Mr. Treat, and Treasurer Caprio. Mr. Costello and Ms. Reback recused themselves from this vote given their absence from the previous meeting.

VOTED: To approve the Minutes of the May 30, 2007 regular meeting.

Subcommittee for Alternative Investments. Treasurer Caprio asked Mr. Reilly and Mr. Goodreau to summarize the first meeting of the Subcommittee for Alternative Investments (S-AI), held June 15, 2007. Mr. Reilly gave a brief overview of the meeting, which interviewed seven companies for presentation to the Commission. Mr. Reilly concluded that the S-AI was subsequently recommending for investment W Capital (in the amount of \$15 million), Avenue Capital (in the amount of \$20 million) and Magna Hospitality Group (in the amount of \$4 million). Mr. Reilly stated that both W and Avenue are firms of previous investment by the Employees' Retirement System of Rhode Island (ERSRI), while Magna would be a new relationship. Mr. Goodreau added that, as per the report presented to Commission members, as much as \$7.5 million is available for investment in Magna, but a consultation with the Townsend Group, real estate consultants to the Commission, had determined that \$4 million is appropriate for the fund at this time.

Treasurer Caprio explained that no representatives for W and Avenue were present because both are existing relationships for the fund, and thus are not required to

make presentations to the Commission. The Treasurer asked Ms. Davidson of PCG to give an overview of the two firms.

Avenue Special Situations Fund V, L.P. (Ave V). Ms. Davidson stated that Ave V is being formed by Avenue Capital Partners, LLC (Avenue) primarily to make non-controlling investments in debt, equity, or other obligations of companies in financial distress. She stated that Avenue maintains offices in New York, London, Luxembourg, New Delhi, Bangkok, Shanghai, and several other East Asian cities; Ave V will be managed primarily from Avenue's New York office and will target North American investments.

Ave V will continue to utilize the same top-down, value investing approach it has employed through four prior distressed funds. Ave V will invest in companies in which there is anticipated turnaround, companies trading below liquidation value, or companies that are undervalued. Avenue has targeted a fund size of \$4.5 to \$5 billion. A hard cap has not been determined. Avenue anticipates a first close on April 18, 2007, and anticipates additional closings.

Ms. Davidson concluded that PCG's review determined Ave V to be an opportunity for the ERSRI to participate in a differentiated portfolio of private equity investments, with potential returns that justify associated risks. Ms. Davidson stated that investment in Ave V is complementary to the ERSRI's existing Special Situations commitments and provides further diversification to the overall portfolio.

Treasurer Caprio stated that the ERSRI's existing relationship with Avenue enables investment in Ave V, whereas a state without such an existing relationship might not have the opportunity.

Mr. Costello inquired as to how the amount of proposed investment was determined. Ms. Davidson answered that the number was reached based on a pacing model and a survey of market-based opportunities, looking at the ERSRI's target for private equity by year and sector, and mindful of diversification as well as policy parameters.

Ms. Gallogly commented that she would support a better allocation strategy that would reward existing, well-performing funds with further or increased investment. In response, Ms. Davidson suggested the possibility of a twice-yearly update of the pacing model to better reach targets.

Mr. Reilly added that he believed a revision of allocation strategy would be beneficial due to changes in the landscape of investments related to "mega-funds". Mr. Reilly further suggested that the ERSRI consider reallocating to firms and funds that are truly venture capital rather than buyout firms.

Treasurer Caprio then entertained a motion for investment in Ave V. Ms. Gallogly moved, Mr. Reilly seconded, and the following motion was passed

unanimously. The following members voted in favor: Ms. Gallogly, Mr. Gaudreau, Mr. Reilly, Mr. Treat, and Treasurer Caprio.

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

W Capital Partners II, L.P. (WII). Ms. Davidson continued with her overview of W Capital Partners (W) and their second fund (WII) for investment by the ERSRI. She stated that W was formed in 2001 and has since managed nineteen portfolios representing more than two hundred investments totaling some \$170 million. As of September 30, 2006, W's investments generated a gross IRR of 39% and a gross TVM of 1.4x; W's first fund ranks in the first quartile relative to data for U.S. venture capital funds. Ms. Davidson stated that W's investment team has broad experience investing across a wide range of industries and at various stages including buyout, growth equity, and across the venture capital spectrum. W pursues direct secondary investments, which Ms. Davidson characterized as a recently emerged niche market opportunity.

Ms. Davidson continued that WII was formed to acquire direct private equity portfolios through the secondary market, and to proactively manage the acquired portfolio companies to generate capital appreciation. W will seek to acquire portfolios valued between \$5-100 million with underlying individual investment values ranging from \$2-30 million. W expects WII to build a portfolio of primarily North American assets that are diversified by industry sector and vintage of original investment. WII will also pursue assets along a broad range of strategies including multiple stages of venture capital, growth equity and buyouts, with particular emphasis on mid- to late-stage venture capital and growth equity investments.

Ms. Davidson concluded that a new commitment to WII would be allocated 100% to the Special Situations Investment sub-sector, and would also provide a further degree of diversification to the overall portfolio. She noted that the \$15 million proposed investment is the same amount as the ERSRI's investment in the original fund.

Ms. Gallogly asked for clarification of W's loss ratio, in comparison with that of other similar firms (such as Avenue). Ms. Davidson answered that W has higher loss ratios reflective of the volatility inherent to their strategy (i.e. purchasing secondary portfolios). She advised the Commission to focus on returns to gauge W's performance, which she judged as quite strong.

Treasurer Caprio entertained a motion for investment in WII. Mr. Reilly moved, Ms. Gallogly seconded, and the following motion was passed unanimously. The following members voted in favor: Ms. Gallogly, Mr. Gaudreau, Mr. Reilly, Mr. Treat, and Treasurer Caprio.

VOTED: To invest up to \$15 million in WII, contingent upon satisfactory review and negotiation of investment and other legal documents.

Magna Hotel Fund III (MHF III). Mr. Goodreau prefaced his overview of Magna Hospitality Group, L.C. (Magna) and MHF III by apologizing for the absence of the Townsend Group, real estate consultant to the Commission, and stating that pressing circumstances had prevented representatives from attending. Mr. Goodreau stated, however, that his communication with Townsend had been consistent and solid in relation to Magna and the general portfolio.

Mr. Goodreau then gave an overview of Magna, stating that he had personally observed the organization and interacted with its management team, based in East Greenwich, Rhode Island, and that he was pleased to see a local company with such successful returns. Mr. Goodreau characterized Magna as a company that develops, manages, and operates hotels. He stated that the company has proven success in its operations, and since 1999 has invested or committed to invest approximately \$400 million in twenty-seven real estate-related investments, having an aggregate value of approximately \$700 million. Mr. Goodreau noted that Magna Capital Management, a subsidiary of Magna, is the sponsor of MHF III.

Mr. Goodreau stated that MHF III has a target size of \$50 to \$75 million. The first closing will be held at the end of June 2007, with the second close targeted for July or August 2007. MHF III is expected to have a gross return of 25%, with net returns of 20% based on fee structure.

Treasurer Caprio commented that Magna is based in Rhode Island but maintains only one local investment. He believes that the thirteen locally-based Magna employees, however, represent the ERSRI's desire to work with the best and the brightest local companies, and to encourage growth within the state. Treasurer Caprio stated that, in addition to being a prudent investment for the ERSRI, he believes that the state's investment will have the effect of boosting Magna's ability to fundraise.

Mr. Goodreau introduced Mr. Robert Indeglia, President and CEO of Magna, who then gave a brief overview of the company as well as his own professional history. He summarized Magna's investment history, stating that the company currently maintains investment in twenty-one hotel properties. Mr. Indeglia underscored that while Magna is a locally-based company, the focus for investment in hotels is not necessarily Rhode Island, but wherever the best investments can be found. He concluded that for MHF III, he expects 6-10 limited partners, and anticipates placing funds within 2-3 years (with liquidation in less than sixteen years).

Ms. Gallogly inquired as to the participation and influence of limited partners in Magna's investments. Mr. Indeglia answered that, while partners are involved in advising committees, Magna is heavily reliant on its own management team for direction and control of day-to-day decisions.

Ms. Reback inquired as to the language presented in Townsend's report on Magna, which she believed to imply that Magna "tends to avoid investment" in union properties. Mr. Indeglia could not comment on the genesis of Townsend's statement, but

clarified that Magna does not expressly avoid or commit to investment in a property based on union presence or lack thereof. He stated that the primary factor in Magna's investments is always a property's assessed potential for positive growth and returns, regardless of union presence.

There being no further questions, Treasurer Caprio entertained a motion for investment in MHF III. Ms. Reback motioned, Mr. Reilly seconded, and the following motion was passed unanimously. The following members voted in favor: Ms. Gallogly, Mr. Gaudreau, Mr. Reilly, Mr. Treat, and Treasurer Caprio.

VOTED: To invest up to \$4 million in WHF III, contingent upon satisfactory review and negotiation of investment and other legal documents.

Following the vote there was some discussion of the S-AI as a means of streamlining the process for presenting and evaluating potential alternative investments to the Commission. Mr. Goodreau and Mr. Reilly stated that they believe the S-AI serves as an additional tool, rather than a substitute or shortcut, for more thorough evaluations than can be performed in SIC meetings alone.

Ms. Reback voiced objection on the grounds of limited time, stating that she would like to take part in all evaluations but was unable to commit to the extra time required by the S-AI. Treasurer Caprio agreed with her concerns for thoroughness, but echoed Mr. Goodreau's and Mr. Reilly's sentiments that the S-AI would be utilized as an additional tool of evaluation, not something to supplant the due diligence already performed by Commission members and consultants to the Commission. Treasurer Caprio also stated that firms without prior relationships with the ERSRI will still be required to be present for review at the SIC meetings, in addition to any S-AI meetings in advance.

Wellington Management Company, LLP – Technical Equity Product (WTEP). Mr. Goodreau gave an overview of Wellington Management Company, LLP (Wellington) and WTEP for potential investment. He stated that the ERSRI has an ongoing and solid relationship with Wellington in other areas, and that Wellington has consistently delivered outstanding numbers. Mr. Goodreau commented that he believes the investment is an opportunity to leverage an existing relationship, and to explore a new tool for assessing and improving fund performance. He further stated that the ERSRI's ongoing relationship with Wellington enabled this investment opportunity that might otherwise be unavailable.

Mr. Goodreau noted that the WTEP is classified as an S&P fund, and recommended moving \$50 million from S&P exposure (totaling \$1.7 billion) for investment in WTEP. Mr. Goodreau stated that given the existing relationship with Wellington and the impending deadline for investment, he wanted to introduce a discussion before losing the opportunity. Once the ERSRI is invested at an initial, lower level, he believes there will be opportunities for further investment.

There was some discussion of the fee structure, which some members believed to be unusually high for institutional investors. Mr. Treat inquired as to whether there were other state or institutional investors in WTEP, and the nature of their fees. Mr. Goodreau stated that he was aware of one other state investor, North Carolina, which had committed \$1 billion to WTEP, but was unaware of their fee structure. Mr. Costello asked if Wilshire is recommending WTEP for investment, and Ms. Bennett confirmed Wilshire's recommendation. Mr. Costello then motioned to move \$50 million from S&P exposure to WTEP recognizing Wilshire's approval of the transaction, and with some attempt to negotiate the fees to a more institutional level.

Treasurer Caprio asked Mr. Goodreau to have a discussion with North Carolina and update the Commission at a future meeting, and Mr. Goodreau agreed. Treasurer Caprio then entertained a motion for investment based on Mr. Costello's suggestions. Mr. Costello moved, Mr. Treat seconded, and the following motion was passed unanimously. The following members voted in favor: Ms. Gallogly, Mr. Gaudreau, Mr. Reilly, Mr. Treat, and Treasurer Caprio.

VOTED: To move \$50 million from allocation in S&P exposure for investment in WTEP, contingent upon satisfactory review and negotiation of investment and other legal documents.

Capital Market Review – Wilshire Associates. Ms. Bennett began her overview by saying that, following strong U.S. markets in the months of April and May, there appeared to be some slowing down in the month of June, which Ms. Bennett attributed to mixed news about the overall economy. She reported that overall economic growth is slower in 2007, although businesses are showing quarterly earnings growth in excess of expectations, and that cheap, available credit remains in good supply. The service sector remains healthy, but the factory sector shows some signs of slowing. Consumer net worth continues to rise and retail sales posted a healthy increase in May, but job growth is sluggish and unemployment remains at 4.5%. In terms of the housing market, new home sales and starts decreased, and prices overall have fallen. As a result of these and other factors, Ms. Bennett observed that consumer confidence has reached a ten-month low.

The U.S. equity market has been volatile, which Ms. Bennett noted should be positive for active managers. In the year to date, large cap stocks outperformed small cap stocks for the first time in roughly six years. Sub-prime mortgage issues may pose a problem for some, such as Lehman Brothers and Bear Stearns, especially in terms of loan defaults. Private equity capital has been flowing into the market to take advantage of the cheaply available credit. Emerging markets (up 18% year-to-date) continue to lead developed markets. European returns have tempered somewhat in 2007 after a strong showing in 2006. Overall in the year to date, Ms. Bennett reported the fund is performing roughly in line with its benchmarks.

Legal Counsel Report. Mr. Gallogly stated that there was no report for the month.

Deputy Treasurer for Finance Report. Mr. Goodreau focused his report on the matter of accounting discrepancies that he addressed in a previous meeting. He stated that certain accounting practices related to private equity can yield some numbers which deceptively appear negative, when in fact the performance is positive. Mr. Goodreau explained that he has therefore classified private equity as a sub-sector in performance reports to yield a more accurate gauge of success. He stated that overall the fund was down roughly eight basis points from its benchmark for the month.

Treasurer's Report. Treasurer Caprio announced that he anticipated the fund would end on yet another high mark in the month of June after previously peaking in May. He thanked Mr. Goodreau and Mr. Reilly for their work with the Subcommittee for Alternative Investments (SA-I) and looks forward to their continued due diligence. Treasurer Caprio reported that he had visited the State Street organization in Boston, and thanked Ms. Tyrrell and Ms. Callahan for their invitation to do so. Finally, Treasurer Caprio noted that due to a legislative statute, SIC members are required to participate in a mandatory training session related to their membership obligations. A training session is scheduled for July 18, 2007, and future sessions are possible for those who are unable to attend.

There being no questions from the members and no new business, Treasurer Caprio entertained a motion to adjourn the meeting. Ms. Reback moved, Mr. Giudici seconded, and the following motion was passed unanimously. The following members voted in favor: Ms. Gallogly, Mr. Gaudreau, Mr. Reilly, Mr. Treat, and Treasurer Caprio.

VOTED: To adjourn the meeting.

There being no further business, the meeting was adjourned at 11:00 a.m.

Respectfully submitted,

Frank T. Caprio
General Treasurer