

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

Regular Meeting May 30 2007

A State Investment Commission (SIC) meeting was held in Room 135, State House, Providence, Rhode Island on Wednesday, May 30, 2007. The Treasurer called the meeting to order at 9:10 a.m.

Membership Roll Call. Present were: Mr. Michael Costello, Ms. Rosemary Booth Gallogly, Mr. Robert Giudici, Dr. Robert McKenna, Mr. Andrew Reilly, and General Treasurer Frank T. Caprio. Also present were: Mr. Kenneth E. Goodreau, Deputy General Treasurer for Finance; Brian Gallogly, Esq., of Brown Rudnick Berlack Israels, Legal Counsel to the Commission; William Bensur, of Wilshire Associates Incorporated, General Consultant to the Commission; Ms. Lisa Tyrrell and Ms. Lara Callahan of State Street Corporation; and other members of the Treasurer's staff. Ms. Marcia Reback was absent.

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

VOTED: To approve the Minutes of the April 25, 2007 regular meeting.

Treasurer Caprio alerted the group that the Townsend Group, real estate consultants to the Commission, had no representative present. Mr. Goodreau explained that representatives of Prudential Real Estate Investors, and PRISA II, a real-estate fund, would make a presentation to the Commission in absence of Townsend representatives. Treasurer Caprio asked Mr. Goodreau for a brief overview of PRISA II, and Mr. Goodreau described the fund as one which possesses a great track record and a more conservative approach to real estate investments. He stated that after discussions between himself and Townsend representatives, he had concluded that PRISA II offers the advantages of a lower fee and an efficient way for the Employees' Retirement System of Rhode Island (ERSRI) portfolio to gain exposure in an underexposed area. He then introduced Mr. Kevin Smith and Mr. Terry McHugh, representatives for PRISA II.

Mr. Smith thanked Mr. Goodreau for his introduction. He gave a brief overview of the fund, which he described as the core fund of Prudential Real Estate Investors with a history of more than 27 years and a long track record of consistent performance to benchmarks. He stated that he believed the fund to be a good opportunity for the State of Rhode Island, and that the fund is only brought out every few years for investment; the current window of opportunity for investment closes on June 1, 2007, or within two days of the May SIC meeting. He further stated that PRISA II is an open-end, enhanced-return pooled fund which began operations in July 1980, and is only open for new investments periodically, with the last reopening in second-quarter 2004.

Mr. McHugh continued that PRISA II has re-opened the fund in 2007 due to existing strong deal flow, need for capital, and strong market fundamentals. He stated that expected capital to be raised for the fund is \$3 billion, from existing and new investors, in addition to \$250 million for the Prudential defined contribution fund. 25% of this capital is expected to be drawn in 2007, with roughly 19% by June 29, 2007. He described the acquisition strategy as having participation in development at the local level, and an 80% focus on the coastal region given the high concentration of real estate growth and value in that region.

Mr. Smith stated that as of March 31, 2007, PRISA II owned 92 investments with a Gross Asset Value of \$6.2 billion and Net Asset value of \$4.4 billion. PRISA II produced more than 4% Total Gross Return in the first-quarter 2007, and rolling four-quarters' Total Gross Return is just less than 20%. After the initial June 29, 2007 draw down of capital, PRISA II leverage was expected to be in the mid-20% range. He concluded by stating that PRISA II expectations for 2007 were to produce a Total Gross Return of 11-14%, and that Prudential is significantly ahead of those projections at present. Mr. Smith and Mr. McHugh then opened for questions by Commission members.

Mr. Giudici asked the representatives to contextualize current market valuations in historical context. Mr. McHugh responded that he does not characterize the current market as having a collapse in value, but rather a steadying, and that he believes that it will stabilize. He further stated that rents are still increasing, and that a stable market is desirable for returns.

Mr. Treat inquired as to the saturation and high vacancy rates in the condominium market in Florida. Mr. McHugh acknowledged the saturation but stated that Prudential has fared well in that market, with two current projects slated for completion. He attributed Prudential's success in this sector to appropriate pricing.

Mr. Giudici inquired as to the state of the commercial sector, and Mr. McHugh answered that offices in coastal regions, particularly the East Coast, San Francisco and Southern California, remain steady. He stated that strong job growth continues to fuel strong demand for office space, but the demand is typically taking the form of leasing opportunities for extant buildings rather than new construction. Mr. Giudici further inquired as to the impact on the commercial sector of mortgage foreclosures in the residential market, and Mr. McHugh responded that to date there has not been a tremendous correlation between the two.

Mr. Reilly asked whether there are markets that Prudential may have avoided in the past, and are now more bullish in pursuing. Mr. McHugh answered that the fund remains unenthusiastic about office space in the Midwest region, but has grown more comfortable with the opportunities and connections in Midwestern retail space.

Mr. Goodreau stated his concerns about liquidity and potential changes in availability of capital due to unstable interest rates. Mr. McHugh stated that the availability of capital for the next three years is not a concern for Prudential; for the market as a whole, he stated that continued raising interest rates might yield fewer buyers but would not likely yield a decrease in available capital.

In conclusion, Mr. Smith reiterated that he believes PRISA II is an excellent fit with the ERSRI portfolio, and feasible despite the near date of closure given that the ERSRI already invests in other Prudential funds and thus benefits from an abbreviated documentation process.

Treasurer Caprio thanked Mr. Smith and Mr. McHugh for their presentation. He informed the Commission that Townsend had recommended investment in Prudential PRISA II in the amount of \$15 million, and that the ERSRI has \$70 million available for real estate allocation. Mr. Smith informed the Commission that PRISA II was currently oversubscribed by approximately 35%. To achieve the \$15 million investment target recommended by Townsend, Treasurer Caprio entertained a motion for investment in the amount of up to \$20 million, pending satisfactory legal review. Mr. Treat moved, Ms. Gallogly seconded and the following motion was passed unanimously. The following members voted in favor: Mr. Costello, Ms. Gallogly, Mr. Giudici, Dr. McKenna, Mr. Reilly, Mr. Treat, and Treasurer Caprio.

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

Capital Market Review – Wilshire Associates. Treasurer Caprio introduced Mr. Bensus for his presentation to the Commission. Mr. Bensus began by stating that the global market is currently unstable due to recent, uncertain market conditions in China. The U.S. economy as a whole has entered a very long business cycle, which will be characterized by greater stability but more moderate growth, as the U.S. economy has matured from one based in manufacturing to one based in service. In general business earnings growth is still increasing but at steadying rates. Consumer confidence is moderate due to concerns over market volatility; consumer net wealth and spending continues to grow, but housing wealth is being replaced by market wealth.

Mr. Bensus said that he expects growth in both U.S. and non-U.S. equities as long as liquidity remains open; U.S. equities continue to see lower growth and returns than non-U.S. equities as they have since the beginning of the decade, and emerging markets continue to outpace developed ones. Mr. Bensus stated that fixed income continues to be uneventful due to a flat yield curve, yet the ERSRI should still fare well in this sector given the fund's long-term strategy. Mid- and small-cap stocks continue to outperform large-cap stocks.

In terms of performance, Mr. Bensus stated that a review conducted by himself and Mr. Goodreau revealed that, overall, the ERSRI portfolio is performing in line with

expectations. From a macro perspective, asset allocations are in line with policy and managers are performing to portfolio benchmarks.

Mr. Bensus gave a brief overview of asset allocation for the purposes of the recent subcommittee appointed to review this facet of the portfolio. He underscored the importance of asset allocation as the most important tool of the ERSRI as a public fund, setting the philosophy and structure for investment and incorporating forward-looking strategy in order to weather various instabilities over time. Mr. Bensus gave a brief overview of the history of the fund's asset allocation, and a summary of current allocation. He outlined a ten-year forecast of expectations for the fund, which sees a median rate of return of about 8%.

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

Deputy Treasurer for Finance Report. Mr. Goodreau commented on the asset allocation review mentioned in Mr. Bensus's report, stating that he expected the assigned subcommittee to meet sometime in the near future. In addition, his staff had been devoting a large percentage of time to surveying and monitoring the fund's allocation, and various means of calculating and assessing it. Mr. Goodreau stated that he determined the fund to have underperformed this month by roughly 30 basis points, or \$24 million dollars, almost all of which is due to the way private equity is calculated; adjusting for accounting practice and lag time brings the performance in line with expectation. He reiterated a disconnect in the calculation, which he attributes to a function of accounting and hopes to gain clarity on this issue by the next SIC meeting.

Some discussion ensued among Mr. Reilly, Mr. Giudici, and Mr. Goodreau as to the specifics of accounting practice. Mr. Goodreau concluded that this was something he intends to examine closely and resolve in the near future.

Treasurer's Report. Treasurer Caprio announced to the Commission a meeting of the Subcommittee for Alternative Investments, to be held on June 15. The meeting will be chaired by Mr. Reilly, and all interested SIC members are invited to attend. Treasurer Caprio stated that in the future, he hopes that all managers who present to the Commission will first be screened by the subcommittee as a means of streamlining the process. Treasurer Caprio addressed the security lending program that had been discussed in the previous meeting, informing the Commission that the change of one fund to another for collateral had resulted in a positive return of \$164,000. He also stated that he looks forward to the correction of accounting practices so that it most accurately portrays the portfolio numbers. Treasurer Caprio concluded with an update of the portfolio value, which he stated is approaching \$8.3 billion in value, with an increase of \$225 million, as of April 30, 2007.

There being no questions from the members and no new business, Treasurer Caprio looked to the Commission to adjourn the meeting.

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

VOTED: To adjourn the meeting.

There being no further business, the meeting was adjourned at 10:30 a.m.

Respectfully submitted,

Frank T. Caprio
General Treasurer