

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

Regular Meeting April 25, 2007

A State Investment Commission (SIC) meeting was held in Room 135, State House, Providence, Rhode Island on Wednesday, April 25, 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, Ms. Marcia Reback, 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; Ms. Michelle Davidson, of the Pacific Corporate Group, Alternative Investments Consultants to the Commission; Ms. Lisa Tyrrell and Ms. Lara Callahan of State Street Corporation; and other members of the Treasurer's staff. Dr. Robert McKenna was absent.

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

VOTED: To approve the Minutes of the March 28, 2007 regular meeting.

Dr. McKenna arrived at 9:10am, and his attendance was noted for the record.

Treasurer Caprio alerted the group to a typographical error in the staff summary section of the SIC book for this month, which incorrectly states a "decrease" rather than an "increase" in the portfolio. Treasurer Caprio reiterated for the record that the portfolio experienced an increase, not a decrease, and that a corrected page would be submitted to all SIC members.

Short Term Investments – Washington Trust. Treasurer Caprio introduced Mr. Vincent Izzo for his presentation to the Commission on Washington Trust (WT). Mr. Izzo began by stating that the ERSRI makes an effort to invest with a local focus, as evidenced by the addition of local entity Webster Bank in the previous SIC meeting and again this month with WT. Mr. Izzo then gave an overview of WT, noting that a full review of WT had been performed and discussed by the Deputy Treasurer and his staff. He noted that WT does not issue publicly traded debt and thus is not rated by an agency such as Moody's or Standard and Poor's, but that WT is rated by a rating service and ranks very highly on that scale. Mr. Izzo stated that WT meets all the criteria required by the Commission, and concluded with the recommendation that WT be adopted as a short-term investments vendor for the ERSRI, bringing the total number of active vendors to eleven.

Ms. Gallogly inquired as to the standard in terms of a rating agency used by banks with which the ERSRI maintains relationships, and whether this is part of the ERSRI investment policy. Mr. Izzo answered yes on both counts, and reiterated that WT meets those standards.

Mr. Costello asked for confirmation of how many managers the ERSRI retains. Mr. Izzo stated that up to fifteen managers is a comfortable number for the ERSRI, and that currently two other managers in addition to WT are under consideration.

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

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

Before moving to the next item on the agenda for review, Treasurer Caprio asked Mr. Izzo for an update on the auction of investments that will be offered to the public by the State. Mr. Izzo stated that the Treasurer's staff has been developing the criteria for auction and a list of potential vendors, and hopes to have a proposal ready to present to the Commission by the next month's meeting.

Ms. Reback inquired as to what exactly will be auctioned, and Treasurer Caprio answered that bond rates will be offered by various banking institutions for 6-month savings CDs. Both approved and non-approved vendors will be able to participate, with benefits both in terms of marketing purposes and beneficial rates of return. Treasurer Caprio noted that similar programs have been employed by other states to positive results.

Alternative Investments (Pacific Corporate Group). Treasurer Caprio introduced Ms. Davidson of Pacific Corporate Group (PCG) to give a brief overview of the Paladin Capital Group (Paladin) and Paladin Capital III (PC III), up for review and investment by the Commission. Ms. Davidson stated that Paladin is raising up to \$500 million for a third fund to pursue the same strategy as their prior fund, which focused on technology companies that offered solutions to help critical infrastructure defend against or recover from natural disasters and homeland security threats. She stated that PCG believes Paladin is a clear leader in this niche, and has assembled an unparalleled team with expertise in fields including national defense, security, technology and intelligence. Principals include former directors of the NSA and CIA, and a strong group of strategic advisors as an additional resource. PCG finds compelling Paladin's concept of dual use, requiring companies in which they invest to have the ability to secure contracts in both the government and the private sector, thus limiting investment risk. Ms. Davidson articulated one primary concern with Paladin, which is that a substantial amount of their prior fund remained unrealized and thus supplied a less clear indicator of future

performance. She stated, however, that PCG views Paladin's strong team as a mitigating factor, and has confidence that Paladin will be able to execute their plan.

Ms. Gallogly asked if ERSRI invested in the prior fund, and Ms. Davidson answered that this would be a new relationship for the ERSRI.

Mr. Costello inquired as to why Paladin was categorized within the PCG report as a venture capital firm if the group does not typically pursue startups. Ms. Davidson replied that while not the traditional model of venture capital, there is a wider category of venture capital into which Paladin falls. She stated that because Paladin invests in technology companies, and is not involved in leverage buyouts per se, the group falls under the definition of venture capital.

Ms. Reback inquired whether Paladin supports any companies such as Halliburton that would indirectly support mercenaries. Ms. Davidson replied that her understanding was that Paladin pursued no such investments, but deflected to Paladin representatives for their presentation to the group.

Paladin Capital Group presentation. Treasurer Caprio presented Mr. Michael Steed and Lieutenant General Kenneth Minihan of the Paladin Capital Group for their presentation. Mr. Steed began by stating that Paladin was founded in 2001, and had a first fund of \$208 million, which was a classic opportunity fund. Following the events of 9/11, the group convened with the idea of developing a strategy of investment in a way that would respond in both a civic and financial way to those events. The group examined the critical infrastructure of the United States in relation to vulnerabilities to natural disasters, terrorism, and other illegal activities. As a result, the group put together a fund that would invest in companies that could contribute solutions to those vulnerabilities as well as bring positive financial returns.

Mr. Steed stated that nearly all the companies in that initial fund are re-upping for the successor fund. In the initial fund twenty-one transactions were closed, fifteen of which closed within the past two years, including one excellent realization. Mr. Steed concurred with Ms. Davidson's assessment of the fund as being rather young, but also stated that the companies within the fund continue to mature nicely. Mr. Steed stated that four of the fund's companies are in early stages of venture capital investment, and the remainder are in what he termed "B", "C", and "D" stages of growth, which he defined as "classic growth equities". Mr. Steed then deferred to Lt. Gen. Minihan to give an overview of the investment team, which Mr. Steed characterized as the top team in the country in focusing on homeland security and critical infrastructure issues.

Lt. Gen. Minihan stated that Paladin assembled its investment advisory team primarily with the concept of dual use in mind, feeling a need for expertise in areas of national security and the public sector as well as technology development and financial growth. He stated that Paladin's team of strategic advisors thus possesses a broad range of areas of expertise. Lt. Gen. Minihan introduced himself as having served thirty-three years in the United States Air Force, before entering the field of national security and

developing expertise in technological development and security infrastructures. He gave an overview of the diversity of the Paladin advisory team, which includes members with backgrounds similar to his own as well as: a medical doctor with interest in long-term modernization of medical care facilities; a hardware and software technological expert; a co-founder of Disney Imagineering who helped design and build Disney and other large-scale theme parks; a Nobel Prize-winner in science with an understanding of biological and chemical hazards; a former ambassador to China with expertise in Asian markets.

Mr. Costello inquired as to whether all the members involved with PCIII were also involved in the initial fund. Mr. Steed answered yes, with the exception of one member who left the firm in order to remain near his home in Boston, and there are also four new members in addition to those involved with the initial fund.

Mr. Steed went on to elaborate the terms “homeland” (the global environment, rather than just the United States), “security” (assurance of the ability to continue work and play in the global environment despite threats), and “critical infrastructure” (the mechanisms and systems relied upon daily for work and play in the global environment) as Paladin defines them. He observed that the realization of vulnerabilities to these systems occurred in the mid-1990s, but that the incidents of 9/11 accelerated the need to find solutions to these vulnerabilities.

Mr. Steed stated that PCIII is a multi-stage fund. Paladin considers several pillars with regard to security: the ability to defend, to cope, and to recover. Using these criteria, Paladin widens the field of consideration for companies of potential investment. Dual use is a critical screen Paladin employs, and companies must scale on both the commercial side and the governmental or defense side. Paladin does not consider itself a defense fund, does not fund weapons or combat, and tends to avoid transactions with companies that are strictly defense-oriented. Mr. Steed further emphasized that companies’ commercial viability is a stronger deciding factor for investment than other facets under evaluation. Companies must appeal to commercial and federal interests.

Ms. Reback asked for clarification of what Paladin means by “services” when it lists its investment companies as providing products, technologies, and services. Lt. Gen. Minihan cited GlassHouse Technologies, Inc., based in Boston, which is a technology consulting service that provides consulting services to the government and other entities with respect to electronic storage systems that are agnostic to those entities’ existing technologies.

Mr. Reilly asked whether the focus of PCIII would be similar to the initial fund, as the language surrounding PCIII appears to be more heavily focused on the homeland security sector. Lt. Gen. Minihan answered that the core business of PCII will be continued in PCIII, with the additional opportunity to do more early-stage investment in PCIII.

Mr. Reilly asked the Paladin representatives to address the competition in their field of investment, which he anticipated had become crowded since Paladin’s initial

fund. Mr. Steed answered that since PCII, risk has shifted from technology to management and growth; Paladin can now, with greater knowledge of technologies, examine companies in earlier stages of growth and acquire better deals. Mr. Steed further observed that Paladin attracts companies because it offers value-added benefits in addition to funding. Finally, Mr. Steed asserted that there is no other fund comparable to Paladin in the United States, and that while competition exists for individual deals, as an entity Paladin dominates the niche in a focused way while also expanding outside that niche with PCIII.

Treasurer Caprio stated to the group that Mr. Reilly has been performing an in-depth analysis of Paladin over the past month as part of his work with the subcommittee on private equity. Treasurer Caprio stated that he anticipates the subcommittee will hold a public meeting for anyone who wishes to participate, in addition to following up with the SIC in future meetings. The analyses generated by the subcommittee will serve as an additional tool to the analyses presented by PCG.

Mr. Costello asked for further information about the single full exit Paladin exercised. Mr. Steed answered that the one full exit was from an investment partnership with a company that produced new technologies for visual monitoring systems. Mr. Steed explained that this company generated novel technologies and had governmental grants, and Paladin anticipated a strong commercial market. According to Mr. Steed, slower-than-expected growth in relevant commercial markets presented problems for continued investment, and Paladin made the decision to divest; Paladin sold the company for \$4.5 million, at a loss of roughly \$6 million. Mr. Steed stated that the fund structure cushions the loss to investors in such cases, requiring Paladin to make up the loss before sharing profits with investors.

Mr. Giudici asked Mr. Steed to elaborate on Paladin's investment team. Mr. Steed answered that there is an investment committee and a deal flow committee that meet on a weekly basis. Mr. Giudici inquired as to the monitoring of investments, and Mr. Steed replied that the team monitors investments on a minute-to-minute basis. He further stated that Paladin's monitoring can be fairly in-depth, going so far as to rearrange management in a company if performance does not meet expectations.

Ms. Gallogly asked for further information about fund performance given that Paladin experienced one full exit in PCII. Mr. Steed replied that he and one other founding partner have a demonstrable performance history in Washington, D.C.-based ULICO, a holding company for subsidiary Union Life Insurance Company, from 1991 to 1999 with an internal rate of return IRR of 81% for realized deals, 90% for realized and unrealized. PCI has an overall IRR of around 17% to date (target of 20%), with an exit from one transaction at as much as 41% IRR. PCII closed in 2004 and currently has an IRR of just under 10%. He reiterated that PCII is a very young fund with twenty-one total companies, fifteen of them realized in the last twenty-four months.

Treasurer Caprio then entertained a motion for investment in PC III in the amount of \$15 million, pending satisfactory legal review. Mr. Treat moved, Ms. Reback

seconded, and the following motion was passed with one negative vote. The following members voted in favor: Mr. Costello, Mr. Giudici, Dr. McKenna, Ms. Reback, Mr. Reilly, Mr. Treat, and Treasurer Caprio. Ms. Gallogly voted against the motion, citing concerns about a lack of fund performance history.

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

Ned Davis Research – Capital Market Review. Treasurer Caprio and Mr. Goodreau stated that he would partially combine the Deputy Treasurer's report with the Capital Market Review, which would be presented by Mr. Ed Cliffold, Senior Global Analyst of Ned Davis Research (NDR), in absence of consultants from the Wilshire group, who were not able to attend. Mr. Goodreau stated that his investment staff had performed due diligence with regard to asset allocation and market research. Mr. Goodreau stated his interest in acquiring as much outside, unbiased research tools as possible to better guide the ERSRI investment decisions. He further stated that he believed NDR to be among the best sources for this sort of information. After some initial technical difficulty in arranging a conference call via speakerphone, it was determined that the call would take place via cellular phone speaker. Mr. Goodreau placed the call and, when it was determined that the group could properly hear Mr. Cliffold, Mr. Cliffold proceeded with his overview.

Mr. Cliffold introduced himself to the group and stated that NDR was founded in 1980 and currently provides financial markets research for more than one thousand entities globally. He stated that NDR considers itself a disciplined risk manager, relying heavily on historical data for context as well as a number of trend indicators. He stated that his overview would touch on current conditions, what those conditions mean to the ERSRI, and finally global markets.

Mr. Cliffold began his overview by explaining that a comparison of earnings expectations with actual earnings in the current cycle shows that analysts' expectations of earnings have been too conservative, which indicates that sentiment has remained somewhat in check despite the bull market. He noted that this is something worth watching closely in the near future, with respect to how long the current trend and rate of earnings growth will continue. Mr. Cliffold further explained that the economy appears to be in a state of soft decline, of which one major indicator is the decline of the lagging housing market. One area of special concern is credit spreads for asset backed securities, which could negatively affect other areas of the economy.

Mr. Cliffold stated that the S&P 500 has declined a significant amount, but qualified this by saying that using the past seven to eight years for comparison is unwise given that this bubble period produced numbers atypical to a broader historical consideration of the economy.

Mr. Cliffold stated that in terms of small and large cap stocks, large caps tend to outperform small caps later in the economic cycle as large caps are typically more economically sensitive. He observed that that trend indicators have begun to favor large cap stocks. Mr. Cliffold stated that value is more favorable than growth currently, but that analysts are watching growth-oriented stocks in fields such as health care for signs of rebound.

Mr. Cliffold moved to international markets, pointing out that Asian markets, specifically China, India, Indonesia, Japan and South Korea, have been driving the global economy. He stated that this should serve as an example that the United States investors should remain continuously watchful of the global economy. Resource markets such as Latin America continue to be favorable as well.

Mr. Goodreau inquired as to how other pension funds have used analysts' estimates to tailor their own investments. Mr. Cliffold responded that the pension funds typically use these estimates as best their investment policy allows, depending upon the flexibility these policies allow for reaction. Less flexibility yields less reactivity, and some performance is generally lost. He stated that models can be tailored to the particulars of each pension fund's policy to reap the greatest benefits within those parameters. Mr. Cliffold interjected that most pension funds like to use these models as an anchor to guide their investments, as a tool to clarify sometimes overwhelming or irrelevant economic data that exists on the whole.

Treasurer Caprio thanked Mr. Cliffold for his report, stated that he believes it very important for the group as a whole to determine the ERSRI asset allocation and the general direction of investments. Mr. Goodreau concurred, and stated that research provided by consultants should be treated as an unbiased eye to the economy, which the group should use to contextualize or guide investment decisions. He further stated that he believed that utilizing as many outside, unbiased tools as possible is best for sound investment decisions.

Legal Counsel Report. Mr. Gallogly stated that there was no report for the month, but took the opportunity to introduce himself to the group as the new legal counsel and replacement for Ms. Jayne Donegan, who had left the firm Brown Rudnick Israels for another position. Mr. Gallogly stated his enthusiasm to work with the group, and Treasurer Caprio thanked him for his efforts thus far and going forward.

Deputy Treasurer for Finance Report. Having presented his report to the group as part of the Capital Markets Review, Mr. Goodreau had nothing further.

Treasurer's Report. Treasurer Caprio stated that he would like to address security lending issues, which the staff has examined for the past month. He stated that just over \$1.3 billion in stock is currently lent by the ERSRI to other entities, and that the ERSRI receives 102% of the stock value in cash from these borrowing entities, which is in turn invested in a vehicle with State Street consisting of three funds: the "A Fund", the "D Fund", and the "Renaissance Fund." Treasurer Caprio clarified that the overall fund

totaled approximately \$100 billion, of which the ERSRI funds constituted roughly \$1.3 billion. At the time of review, the “A Fund” consisted of various rated instruments (mostly AA and AAA bonds) with no exposure to mortgage-backed or credit-card securities, as opposed to the “D Fund,” which had 60% exposure to mortgage and credit-card securities (some of which were unrated). Rhode Island had traditionally been involved with the “A Fund,” but had switched from “A” to “D” with the approval of the Commission in 2006. Treasurer Caprio stated that following a conference call between himself and Mr. Goodreau and representatives of State Street, and given current economic conditions, he believed it prudent to scale back on the risk in this area, switching money from the “D Fund” to the “A Fund”. Since it was consistent with the Commission’s approval for the ERSRI to be invested in the “A Fund”, Mr. Goodreau and Treasurer Caprio approved the switch from “D” back into “A”, which has since been completed.

Ms. Reback motioned to request confirmation to the Commission of the movement of funds from “D” to “A”. Mr. Costello seconded, and the following motion was passed unanimously. The following members voted in favor: Mr. Costello, Ms. Gallogly, Mr. Giudici, Dr. McKenna, Ms. Reback, Mr. Reilly, Mr. Treat, and Treasurer Caprio.

Ms. Reback additionally requested advance notice in the future of any such movements on behalf of the ERSRI. Mr. Goodreau agreed.

VOTED: To receive confirmation to the State Investment Commission (SIC) of the movement of ERSRI funds from the “D Fund” to the “A Fund” within the State Street investment vehicle.

There being no questions from the members and no new business, Treasurer Caprio looked to the Commission to adjourn the 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, Dr. McKenna, Ms. Reback, Mr. Reilly, Mr. Treat, and Treasurer Caprio.

VOTED: To adjourn the meeting.

There being no further business, the meeting was adjourned at 11:05 a.m.

Respectfully submitted,

Frank T. Caprio
General Treasurer

