

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

Regular Meeting March 28, 2007

A State Investment Commission (SIC) meeting was held in Room 135, State House, Providence, Rhode Island on Wednesday, March 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, Ms. Marcia Reback, Mr. Andrew Reilly, and General Treasurer Frank T. Caprio. Also present were: Mr. Kenneth E. Goodreau, Deputy General Treasurer for Finance; Jayne Donegan, Esq., of Brown Rudnick Berlack Israels, Legal Counsel to the Commission; Mr. David Lindberg, of Wilshire Associates Incorporated, General Consultant to the Commission; Mr. David Fann 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.

State Investment Commission Minutes. Mr. Costello 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 approve the Minutes of the February 28, 2007 regular meeting.

Private Equity Review (Pacific Corporate Group). Treasurer Caprio introduced Mr. Fann of Pacific Corporate Group (PCG). Mr. Fann briefly outlined his overview of the fund, stating that the portfolio on an aggregate basis has outperformed all benchmarks including venture capital and the S&P 500. Mr. Fann noted that in terms of asset allocation, PCG has shifted sector focus funds from special situations classification to corporate finance in general, which has yielded an ostensible over-allocation in corporate finance. He explained the reasoning behind this as both temporary and a function of the reclassification of corporate finance, anticipating that the asset allocation will readjust by the end of 2007.

Mr. Costello inquired as to PCG's approach to fund size, and Mr. Fann replied that PCG believes in a diversified approach. He further stated that while there is currently a bias towards middle- and large-sized funds, this is a temporal phenomenon given the recent successes of these types of funds in the marketplace.

Treasurer Caprio asked Mr. Fann for information particular to Lehman Brothers (Lehman), an alternative investment firm seeking investment in their new fund by the ERSRI. Mr. Fann stated that Lehman is a merchant banking organization currently raising a fourth fund with a target size of \$1.5 billion. He introduced the firm as one that has invested \$3.4 billion in 41 companies since 1989 with impressive net internal returns

of 29.7% (gross 37%). Mr. Fann characterized the fund as high quality and compelling, and a good fit in the context of the ERSRI portfolio. Mr. Fann stated that PCG recommends investment in Lehman by the ERSRI in the amount of \$15 million in Lehman Brothers Fund IV (LB IV).

Lehman Brothers presentation. Treasurer Caprio thanked Mr. Fann and introduced Danny James of Lehman for his presentation to the Commission.

Mr. James thanked Treasurer Caprio for his introduction and introduced himself to the Commission as a member of the Lehman organization for twenty years. Mr. James characterized Lehman as a firm competing exclusively in middle markets, targeting companies valued between roughly \$700 million and \$1 billion. He stated that the firm is by far the largest investor in its funds, oftentimes at five to ten times the shared risk as its limited partners. He emphasized that a chief advantage of Lehman is that the firm does not believe in solely investing with outside capital, but is committed to high levels of risk sharing and investment with the firm's own capital.

Mr. James explained that Lehman employs a business model similar to the bulk of private equity firms, in which Lehman receives 20% carried interest from returns. He stated further that Lehman emphasizes risk-reward, whereas offering economic incentive for success secures better performance for all involved investors.

Mr. James gave an overview of Lehman Brothers Fund III, stating that the fund exemplifies the firm's commitment to diversification as well as its overall solid returns. He further stated that sixteen of seventeen deals closed by the fund were proprietary in nature, exemplifying the firm's success in following through on potential ventures.

Moving to Fund IV, Mr. James emphasized the firm's commitment to remaining in the middle market, and to diversification by geography and industry. And finally, Mr. James assured the Commission that investment in LB IV would work alongside rather than in competition with the ERSRI's other investments.

Mr. Giudici inquired as to the internal structure of Lehman, with particular respect to the number of members and the firm's investment philosophy. Mr. James responded that Lehman utilizes a "farm system" approach, typically hiring first-year analysts and/or first-year MBAs who are then trained and promoted within the firm. Mr. James characterized the approach as a collegial one that emphasizes partnership and risk-sharing in its investments. He noted that the same strategy is employed by the firm's European partners.

Ms. Gallogly asked Mr. James to elaborate on the firm's performance and transaction history. Mr. James responded that Lehman has exercised 42 transactions since 1989 and has lost all its money only once. He characterized this instance as an anomaly resultant from complications related to the firm's founder and family, which have since been corrected. Mr. James stated that Lehman approaches its capital seriously with the assumption and expectation of good performance, underscored by the firm's

insistence on risk-sharing by its members and partners. He further stated that Lehman is firmly opposed to bankruptcy, more so than other firms, and approaches risk with caution.

Mr. Costello inquired as to how many deals Mr. James expected to do in Fund IV, and Mr. James responded that he expects fifteen to twenty deals over the next three- to five-year period. Mr. James then asked the Commission for any further questions regarding Lehman or LB IV, and there were none.

Treasurer Caprio then entertained a motion for investment in LB IV in the amount of \$15 million, pending satisfactory legal review. Mr. Treat moved, Ms. Reback 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 invest up to \$15 million in LB IV, contingent upon satisfactory review and negotiation of investment and other legal documents.

Short Term Investments – Webster Bank. Treasurer Caprio introduced Mr. Vincent Izzo for his presentation to the Commission on Webster Bank (WB). Mr. Izzo began by stating that the ERSRI typically operates with twelve vendors, and currently has only eight active vendors. Mr. Izzo stated that a full review of WB had been performed and discussed by the Deputy Treasurer and his staff. He noted that WB is a growing presence in Rhode Island, and is the second largest independent bank in New England, with rates in line with or better than its competitors. Mr. Izzo stated that WB meets all the criteria required by the Commission, and concluded with the recommendation that WB be adopted as a short-term investments vendor for the ERSRI.

Mr. Giudici moved, Mr. Reilly 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, Mr. Treat and Treasurer Caprio.

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

Wilshire Associates Incorporated – Capital Market Review. Treasurer Caprio introduced Mr. Lindberg of Wilshire for his update on capital markets. Mr. Lindberg thanked Treasurer Caprio for his introduction and distributed materials to the group. He began by characterizing the recent period in the marketplace as one of volatility, and quite different from the same period in recent years. Mr. Lindberg stated that the long-term strategy of the ERSRI weathers this volatility well, and urged the Commission to stay focused on the long term policy.

Mr. Lindberg stated that January 2007 saw positive returns, followed by a decline in February, and then a moderate upturn in March in terms of the equity markets. In the year to date, businesses have shown solid growth and consumer spending remains strong.

The real estate market has seen significant and continuing declines, particularly in terms of home sales. There remains some concern regarding inflation rates.

Stocks on the S&P 500 are up about 1% year to date. Small cap stocks have continued to outperform large cap stocks, continuing the trend for the last six years. Equities in emerging markets have cooled somewhat relative to developed markets, although international markets overall remain strong in the year to date. Fixed income equities are up 1.6%, and high yield equities have seen solid returns of 2.5% despite rather compressed spreads and an inverted yield curve.

Ms. Gallogly inquired as to the status of the rebalancing of the ERSRI portfolio as approved in the February 2007 SIC meeting. Mr. Goodreau answered that the rebalancing has indeed taken place, and would address the matter in more detail in his report to the Commission. Mr. Goodreau noted that the money liquidated from Shenkman Capital will be reflected in the asset allocation numbers under the fixed income category.

Treasurer Caprio thanked Mr. Lindberg for his report, and announced the Legal Counsel Report.

Legal Counsel Report. Ms. Donegan stated that there was no legal report for this month. Treasurer Caprio thanked her, and moved to Deputy Treasurer Goodreau for his report.

Deputy Treasurer for Finance Report. Mr. Goodreau thanked the Treasurer and focused his report on the status of funds with Shenkman Capital, formerly an investment manager for the ERSRI. Mr. Goodreau reiterated that the liquidation from Shenkman Capital, which was approved in the previous SIC meeting, had been completed and that the resultant shift will be visible in the next month's portfolio numbers. Mr. Goodreau stated that this rebalancing is reflective of the due diligence in monitoring the performances and practices of the entities with which the State of Rhode Island maintains investment relationships.

Treasurer's Report. Treasurer Caprio thanked Mr. Goodreau for his report. The Treasurer then stated that he intends to establish a subcommittee for alternative investments, for the purpose of reviewing both current and potential funds for investment by the ERSRI. Additionally, this subcommittee will aid the SIC in creating a clear process for approaching investment by the ERSRI in new and/or potential funds. Treasurer Caprio announced that Mr. Reilly has been appointed to this committee, and extended an invitation to other interested members. The Treasurer stated that he also intends to establish a subcommittee on asset allocation, and extended an invitation to interested members as well.

Treasurer Caprio then presented the Commission with an update on legislative matters, particularly the issue of divestment in the amount of \$2 million from Sudan by the State of Rhode Island. The Treasurer noted that the issue is set for a vote in the State

House of Representatives, and that the \$2 million divestment would have minimal impact on the ERSRI but would send a strong message from the state.

Finally, 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 10:10 a.m.

Respectfully submitted,

Frank T. Caprio
General Treasurer