

STATE INVESTMENT COMMISSION State of Rhode Island and Providence Plantations

Regular Meeting August 22, 2007

A State Investment Commission (SIC) meeting was held in Room 135, State House, Providence, Rhode Island on Wednesday, August 22, 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 Gaudreau, Mr. Robert Giudici, Dr. Robert McKenna, Ms. Marcia Reback, Mr. John Treat, and General Treasurer Frank T. Caprio. Mr. Andrew Reilly was absent. Also present were: Mr. Kenneth E. Goodreau, Deputy General Treasurer for Finance; Mr. William Bensus, and Ms. Julia Bonafede, of Wilshire Associates Incorporated, General Consultant to the Commission; Ms. Lisa Tyrrell of the State Street Corporation; and other members of the Treasurer's staff.

State Investment Commission Minutes. Treasurer Caprio noted Ms. Reback's name was incorrectly included in a vote in the meeting minutes from July 25, 2007. With this correction noted, the Treasurer entertained a motion for approval of the minutes. Mr. Costello moved, Ms. Gallogly seconded and the following motion was passed unanimously. The following members voted in favor: Mr. Costello,

Ms. Gallogly, Mr. Gaudreau, Mr. Giudici, Dr. McKenna, Mr. Treat, and Treasurer Caprio. Ms. Reback recused herself from this vote given her absence from the previous meeting.

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

Manager Review – Taplin, Canida & Habacht. Mr. Bensur of Wilshire gave a brief overview of Taplin, Canida & Habacht (TCH) before introducing firm representatives Mr. Alan Habacht, Principal, and Mr. Corey Amon, Director of Research, for their presentation to the Commission. Mr. Habacht described TCH as a 22-year-old firm based in Miami with a focus of fixed income and \$8.3 billion currently under management. TCH was retained in 1996 to provide the Employees' Retirement System of Rhode Island (ERSRI) with a strategic market allocation to the general investment characteristics of the corporate sector of the U.S. fixed income market. The ERSRI is classified as a corporate client.

Mr. Habacht turned to Mr. Amon to give an overview of TCH research strategies and processes. Mr. Amon noted that his team engages in both quantitative research and fundamental credit research. Quantitative research employs spread analysis, scenario analysis, breakeven analysis, and horizon analysis along with archived data of 100 sub-sectors of the fixed income market. He stated that the research team has extensive knowledge of the trading environment, and works closely with the portfolio management team to enable

efficient and timely decision-making. TCH's proprietary analytical tools support this integrated approach.

Mr. Habacht characterized the TCH investment philosophy as emphasizing long-term growth by incorporating quality control by means of credit analysis and prudent diversification of assets; preservation of capital is stressed through strict adherence to risk controls throughout the investment process. Mr. Habacht anticipates that future growth of assets under management will be disciplined and responsible, and that much of the growth will come from current clients.

Mr. Habacht described the investment team as consisting of the three original members with no turnover, which he noted is indicative of the firm's stability and consistency. Mr. Habacht summarized TCH's objectives as: (1) to generate a total return of 30 basis points, net of fees, over the Lehman Credit Index over a three- to five-year horizon; and (2) to generate a total return that ranks in the top 30% of the Wilshire Corporate Fixed Income Manager Universe over a three-to five-year horizon. Mr. Habacht assessed TCH's compliance with these objectives as having exceeded the benchmark by 0.42% on a three-year basis and by 1.57% on a five-year basis. Additionally, Mr. Habacht noted that the portfolio return ranks in the 35th percentile over a three-year trailing period and in the tenth percentile over a five-year trailing period.

In terms of risk management, Mr. Habacht noted that TCH maintained strict compliance to benchmarks via sophisticated analytics and daily monitoring. He added that TCH developed its own monitoring program to improve this process. In conclusion, he thanked the Commission for the longstanding relationship between TCH and the ERSRI, dating back to an initial investment of \$15 million in 1996.

Mr. Amon gave an overview of TCH's research and analysis. He commented on the recent federal rate cuts and a global scenario of tight liquidity. He stated that despite these factors he is optimistic about the current environment, characterizing the situation as one of normalizing prices that will prove advantageous for the fund going forward.

Treasurer Caprio inquired about the under performance of two specific holdings in our portfolio: Harrah's and Ford. He asked Mr. Amon if the Committee should consider exiting these holdings. Mr. Habacht stated that Ford is currently priced at .78 on the dollar. There have been some concerns regarding bankruptcy but the holdings have been performing well in the last four months. Mr. Habacht suggested we hold our position. Mr. Amon stated that Harrah's was subject to a private equity transaction and literally over night the bonds went from almost par to .80 on the dollar. If the transaction is completed there may be some improvement in pricing. It was suggested we hold our position.

Ms. Gallogly noted the presence of Countrywide Financial in the fund and asked Mr. Amon to comment, given the current volatility of that particular company. Mr. Amon stated that he anticipates a volatile future for Countrywide, but that this will be a credit-neutral event for TCH. Mr. Amon explained that Countrywide had reduced its subprime exposure in the months prior to the credit tightening, and it remains less than many other lenders. Mr. Amon reiterated that he believed this to be a significant but short-lived liquidity squeeze, adding that federal banks stand ready to provide liquidity as necessary.

Ms. Gallogly asked if there are other firms of concern in the fund, in addition to Countrywide. Mr. Habacht answered that his concerns are not with any particular firm, but the more generalized problem of liquidity.

Capital Market Review – Wilshire Associates. Mr. Bensur began his overview with general market observations, stating that economic growth had been slower to date in 2007; Mr. Bensur expects this trend to continue. Quarterly business earnings growth is in line with expectations, with some companies “guiding down”; the service sector remains healthy, but the factory sector shows some signs of slowing. Additionally, industrial output rose in the second quarter. Job growth is sluggish, with an unemployment rate of 4.5%. Retail sales posted a healthy increase in the second quarter, and overall consumer net worth continues to rise. In terms of the housing market, new home sales and starts decreased, and prices on the

whole have fallen.

Mr. Bensur noted that the U.S. equity market has been volatile, but that markets have been encouraged by profit reports. He commented that private equity, as exemplified by the Blackstone Group's recent foray into public offerings, has been unusually active in public markets but that financing may be drying up. In the year to date, large cap stocks outperformed small cap stocks for the first time in roughly six years. In terms of international markets, Mr. Bensur observed that emerging markets continue to lead developed markets. European central banks have tightened, and European returns have been stronger than Japanese and U.S. returns. In Asia the yen has rallied, reducing the attractiveness of the yen-dollar carry trade, and Mr. Bensur noted some concern over the safety of Chinese imports has cautioned investors towards that market area.

The Federal Reserve cut discount rates by 50 basis points; the discount rate is now 5.75% (down from 6.25%) but the federal funds rate remains at 5.25%. Mr. Bensur commented that these cuts are due to rising credit concerns in the U.S. and global markets. Ten-year Treasury yields are near a rate of 4.60%, down from 5.00%; rates are expected to be reduced before year-end 2007, as fears of a subprime mortgage "contagion" continue. Mr. Bensur concluded that he believes the proactive measures taken early this year to reduce risk, especially in terms of reduced high-yield exposure, successfully reduced the portfolio's potential losses in the current volatile

markets.

Legal Counsel Report. Treasurer Caprio stated that there was no legal counsel report for the month. Mr. Brian Gallogly of Brown, Rudnick, Berlack Israels, LLP, legal counsel to the Commission, was not present.

Deputy Treasurer for Finance Report. Mr. Goodreau echoed Mr. Bensusur's comments on the measures taken toward proactive insulation earlier this year. He stated that these proactive measures should provide the Commission with investor confidence. Additionally, Mr. Goodreau noted that the current volatile economic environment provides the Commission an opportunity to distinguish funds and companies that are truly good performers, versus those who perform well only in good environments. He drew the Commission's attention to two firms, The Boston Company and PIMCO, which are now under internal watch due to continued underperformance. He stated further that it remains to be seen whether The Boston Company is able to use their conservative strategy to safeguard against losses in the current market volatility, and that PIMCO's portable alpha strategy has yielded returns that are consistently but not drastically underperforming. He concluded that he will continue to update the Commission on these two firms. Finally, Mr. Goodreau noted that asset allocation remains a prime focus for him and his staff, and that proper alignment is the best way to improve overall portfolio performance in the long term.

Mr. Costello inquired as to the current state of the portfolio. Mr. Goodreau answered that it is currently down 150 basis points, but that he does not believe this is worrisome in the long term. He added that he would like to bring private equity holdings in line with policy parameters and that once this is corrected, the portfolio will be in even better standing going forward.

Ned Davis Research Group – Presentation. Treasurer Caprio welcomed Mr. Bruce Kaminsky, Director of Institutional Sales, and Mr. Tim Hayes, Chief Investment Strategist, of Ned Davis Research Group (NDR) for their presentation to the Commission. Mr. Kaminsky characterized NDR as an independent, institutional research company founded in 1980 with the goal of providing unbiased and comprehensive investment research to institutional clients. NDR employs a global, top-down approach and specializes in providing a strategic, tactical view on asset allocation. NDR holds no stocks or other investments.

Mr. Hayes described NDR's research philosophy as objective, disciplined, risk-averse and flexible. As part of their risk-management strategy, NDR advises clients to focus on the reality of the markets (i.e. what is happening rather than what should happen), to synchronize investment decisions with federal economic policies and actions, and to avoid market extremes. Mr. Hayes stated that NDR works with its clients to develop asset allocation models

tailored to the client's interests and resources.

Mr. Goodreau commented that he viewed NDR as an additional tool that the Commission can use in conjunction with its consultants as a way to broaden the field of available knowledge. He considers it the Commission's fiduciary responsibility to maintain the highest financial awareness possible in the interest of sound decision-making.

Ms. Reback asked Treasurer Caprio to clarify how the research from NDR might be used and expressed reticence at the possibility of excessive investment changes. Treasurer Caprio clarified that the research would not be used to direct immediate investment decisions, but rather would serve as a supplemental tool in conjunction with the information from consultants. Mr. Goodreau concurred that he intended the research from NDR to function as guidance rather than explicit direction.

Treasurer's Report. Treasurer Caprio first announced that ratings agencies (Moody's, Fitch, and Standard & Poor's) had confirmed the State of Rhode Island's credit rating; the rating remained at a split rating of Aa3, AA, and AA respectively. Secondly, Treasurer Caprio announced that the auction for interest rates, as previously discussed by the Commission, would open following that day's meeting on August 23, 2007. Finally, Treasurer Caprio informed the Commission that the Treasurer's Office is preparing Requests for

Proposals (RFPs) in order to solicit bids for all outside consulting work performed for the Commission. Treasurer Caprio further stated that firms submitting bids may consider the multiple functions performed by each of the current consultants separately, in boutique fashion, or as a whole.

New Business. There being no further new business, the Treasurer entertained a motion to adjourn.

Ms. Reback moved, Dr. McKenna seconded and the following motion was passed unanimously. The following members voted in favor: Mr. Costello, Ms. Gallogly, Mr. Giudici, Mr. Gaudreau, Dr. McKenna, Ms. Reback, 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**