

# **State of Rhode Island and Providence Plantations**

## **STATE INVESTMENT COMMISSION**

**Regular Meeting February 27, 2008**

**A State Investment Commission (SIC) meeting was held in Room 135, State House, Providence, Rhode Island on Wednesday, February 27, 2008. The Treasurer called the meeting to order at 9:00 a.m.**

**Membership Roll Call. Present were: Mr. Michael Costello, Ms. Rosemary Booth Gallogly, Mr. Robert Gaudreau, Mr. Robert Giudici, Dr. Robert McKenna, Mr. John Treat, and General Treasurer Frank T. Caprio. Also present were: Mr. Kenneth E. Goodreau, Deputy General Treasurer for Finance; Sarah Dowling, of Adler Pollock & Sheehan and Mr. Joseph Rodio of Rodio & Ursillo, Legal Counsel to the Commission; Mr. William Bensus, 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. Ms. Reback and Mr. Reilly were absent.**

**State Investment Commission Minutes. The Treasurer entertained a motion for approval of the minutes. Mr. Costello moved, Dr. McKenna seconded and the 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.**

**VOTED: To approve the Minutes of the January 23, 2008 regular meeting.**

**Manager Continuation Policy Analysis & Review – NorthPointe Capital. Mr. Bensus stated that NorthPointe Capital was retained in 2002 to provide strategic exposure to the small core value segment of the U.S. equity market. The objective of the fund is to generate a total return of 200 basis points, net of fees, over the Russell 2000 Index for a three to five year period and rank in the top 30% of all professionally managed small cap value accounts. The net return lags the index by 48 basis points over the three year period, but exceeds the benchmark by 70 basis points, net of fees, since inception. As of December 31, 2007, the portfolio's market value was \$376.7 million. NorthPointe comprises 10.6% of the total U.S. equity structure, which is about half of the small cap allocation within the portfolio.**

**Mr. Bensus introduced Kenneth C. Hudson, Partner and Chief Marketing Officer and Jeffrey C. Pethrick, Founding Partner & Portfolio Manager. Mr. Pethrick went on to give a brief history of the Firm. It was started in 2000 with Nationwide Insurance Company as a substantial equity partner. In October 2007 they bought Nationwide's equity share in NorthPointe. The Firm is now owned in its entirety by the employees; this allowed them to expand from four original partners to eleven.**

**Mr. Pethrick stated that NorthPointe has been in the top quartile of all small cap managers in the U.S. since inception. The last five years have been a very difficult period.**

**Particularly 2007, where NorthPointe lagged the benchmark by 450 basis points. Despite the current volatility in the market, the philosophy of the Company continues to be that fundamental progress in companies drives valuations over an extended period of time.**

**Treasurer Caprio asked Mr. Pethrick to specify when he felt this period of volatility began. Mr. Pethrick responded that he was referring to the last three years which have been extremely volatile. He went on to explain that hedge funds have increased in the last eight years from approximately 1000 funds to 8000 funds. Since these funds are very flexible and are able to move money quickly according to market conditions, they are well suited for the current environment. This has required NorthPointe to focus on the solid fundamental companies within their portfolio.**

**Mr. Pethrick stated from 2002 to 2008 there has been a deep market value, meaning the market has chased the lowest priced to book stocks, highest leveraged stocks, and companies leveraged toward a cyclical recovery. Mr. Pethrick went on to explain that NorthPointe is a core value or relative value manager. Over a long period of time being a relative value manager will result in good returns. Past performance has indicated that seven out of ten years will produce a**

market that is more “middle of the road” without the extremes we saw in 2007. The market has been in an environment where small core stocks have been moving up since 1999 and this trend should continue.

Mr. Pethrick gave a review of NorthPointe’s performance for 2007. There was a big gap between the Russell 2000 Value which was down 10% and the Russell 2000 Growth which was up about 6%. This resulted in a 1600 basis point swing concentrated in the highest growth and beta type of stocks. The risk within the portfolio is reduced by diversification in market segments. Last year financials were one of the worst performing sectors of the portfolio. Relative to financials, NorthPointe was very under weight compared to the Russell 2000 Value but slightly over weight compared to the Russell 2000. Being over weight in technology was another disappointment resulting in a loss of 200 basis points. The high risk and beta technology funds were in favor as opposed to the conservative funds that NorthPointe carries in the portfolio. By the end of 2007 they corrected this situation by adding conservative value funds in both health care and technology. Future growth is expected to be 14% - 15% which is substantially better than the Russell 2000 Value and in line with the Russell 2000. The portfolio consists of high quality, conservative companies which will give an exceptional rate of return over time. The average rate of return since inception has been 14.8%. The portfolio started with \$100 million and over the last five years ERSRI has added \$54 million; today the portfolio is worth \$376

million. NorthPointe stated that they were hired for small core space and their strategy works well and surpasses the benchmark consistently over time. They are a solid manager and are highly motivated toward achieving our investment goals.

Treasurer Caprio asked if we are still their largest client. Mr. Pethrick replied that our portfolio has the largest dollar investment within their Firm. Treasurer Caprio asked whether the Russell 2000 or the Russell 2000 Value Index is their benchmark. Mr. Pethrick replied that the Russell 2000 is the benchmark, but they strive to surpass both.

Mr. Costello asked what NorthPointe is doing to protect ERSRI against the effect hedge funds are having on our portfolio. Mr. Pethrick replied that he does not believe the current 8000 active hedge funds are here to stay. In the last five years the average hedge fund has barely had a rate of return above treasuries but they continue to charge a 2% fee and 20% on the up side. These funds are giving mediocre returns with huge fees. The situation is not being ignored and NorthPointe is being proactive to minimize the effect on our portfolio.

Wilshire Associates Incorporated – Capital Markets Review. Mr. Bensur began by stating that inflation is over 4%; there are talks of recession and stagflation. It is unclear whether the economic stimulus package will have any significant affect on the economy. Consumer confidence fell to a sixteen year low in February. The U.S.

**equity market will be volatile through 2008. Value is outpacing growth, with large and small caps remaining comparable. The U.S. mortgage crisis has had a negative affect on emerging and developed markets as they continue to fall. The Federal Reserve has cut rates by 1.25% in eight days with more cuts anticipated. The auction-rate markets are having a very difficult time raising capital. The treasury yield curve has fallen and yield versus treasury spreads have widened.**

**Mr. Bensus gave the following report regarding market conditions as of the close of business on February 21, 2008: S&P 500 was down 5.5%; small caps were down 5.9 % but have recovered somewhat in the past two days; Wilshire 5000 was down 5.5 % but has recovered by 2.5-3% in the past two days; the developed markets were down about 6% ; emerging markets were down 4.5% ; the ACW was down about 5.5%; bond indexes were up about 20 basis points; high yield was down about 2% on a year to date basis.**

**Mr. Bensus went on to give a brief overview of asset allocation relative to other large defined benefit retirement plans. ERSRI is performing in the top quartile in comparison to other large state public funds. This was a result of returns from alternative investments, real estate, and private equity. The traditional asset classes have not performed as well in terms of excess returns. The Boston Company and Goldman Sachs struggled last year in non-U.S. equity space. This situation will continue to be monitored.**

**Ms. Gallogly asked Mr. Bensus if it was possible to attribute poor performance to individual managers. Mr. Bensus replied that NorthPointe and Wellington under performed in small cap exposure within U.S. equity. The Boston Company was responsible for poor returns in non-U.S. equity and recently Goldman Sachs has under performed. Taplin, Canida & Habacht has not performed well in fixed income, which is related to the credit spread. Mr. Goodreau stated that Fidelity has also under performed against their benchmark in fixed income.**

**Mr. Bensus went on to give a brief history of the total fund performance. The market value of the portfolio in December 31, 1983 was \$0.7 billion. The ending market value as of December 31, 2007 was \$8.5 billion. The portfolio's annualized compounded rate of return over this 24 year period was 10.80% per year. The unfunded liability at 2007 year end was approximately 50%.**

**Proposed Investment in Point 406 Ventures I, L.P. Ms. Michelle Davidson of Pacific Corporate Group gave an overview of Point 406 Ventures, I. The Firm, which is located in the Boston area, was founded in 2005 by General Partners Larry Begley, Maria Cirino, and Liam Donohue to make seed and early stage investments in information technology and technology-enabled services. Point 406 will build a Venture Capital Portfolio of approximately 20 to 25 companies and make four to five new investments per year**

concentrated in the Northeast Region. The General Partner expects to invest \$6 to \$10 million in each company, with initial investment sizes ranging from \$0.5 million to \$3 million. Ownership stakes for each company will be 20% to 80%. The fund is targeting \$150 million in aggregate commitments. Ms. Davidson stated it has been a challenge finding firms who invest in early stage venture capital which results in less exposure to risk. A commitment to the Fund is complementary to ERSRI's existing venture capital commitments and provides the overall portfolio with additional diversification. The management fee is 2.5% of aggregate commitments with a carried interest split of 80%/20%.

Ms. Maria Cirino, General Partner and Mr. Greg Dracon, Co-Founder and Principal, represented Point 406 Ventures, L. Ms. Cirino began by giving an overview of the experience of the investment team. Treasurer Caprio added that PCG made a recommendation for investment in November 2007 but a commitment was not made at that time due to market volatility. Ms. Cirino went on to explain why early stage venture capital is an asset to the portfolio: venture capital outperforms buyouts and other classes of private equity; early stage venture capital leads all venture capital fund types by a considerable margin; early stage venture capital significantly outperforms public markets over time. Mr. Dracon explained who their extensive network of investors is and the strategies used when choosing new investors. They look at fifteen hundred to two thousand potential investments each year, but only choose to make an offer to four to six

companies.

Mr. Costello stated that it is rare for the Commission to be asked to invest \$10 million in a first fund. He asked Ms. Davidson to explain the reasons she suggests this size investment. She replied that the combination of expertise among the Principals is one reason. They have solid venture capital experience combined with operating experience. The portfolio already has significant momentum which validates the opportunity and strategy of the team. Ms. Davidson has done extensive research on each of the nine companies which make up their portfolio and feels confident this is a good fit for ERSRI. Ms. Davidson remarked that ERSRI did invest in a first time fund in 2002 with Thomas McNerney Partners with a commitment of \$15 million.

Ms. Gallogly asked what the management fee will be over the life of the fund.

Ms. Cirino explained that fees are used to fund operations to run the Firm. The carried interest split is 20% of the profit on the liquidity. Ms. Davidson interjected that the fee will never exceed 2.5% over the life of the fund.

Mr. Costello moved, Ms. Gallogly and Mr. Gaudreau 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.

**VOTED: To invest \$10 million in Point 406 Ventures I, L.P. contingent upon satisfactory review and negotiation of investment and other legal documents.**

**Legal Counsel Report.** Treasurer Caprio introduced the new Legal Counsel as Ms. Sarah Dowling of Adler Pollock & Sheehan P.C., who will be handling all investment transactions and Mr. Joseph Rodio from Rodio & Ursillo Ltd, who will handle administrative transactions.

**This change will be beneficial as it will lower costs associated with legal fees.**

**Deputy Treasurer for Finance Report.** Mr. Goodreau announced the first sub-committee meeting for the selection of Consultant to the Commission was held last week. He thanked Mr. Costello, Mr. Goodreau, Mr. Reilly and Mr. Treat for their participation. The next meeting will be scheduled shortly with intentions of narrowing the choices to three to four of the most qualified firms.

**Treasurer's Report.** Treasurer Caprio complimented the efforts and dedication of all those who are participating in the Consultant selection process. He noted that there will be another meeting scheduled in March.

**New Business.** There being no questions and no new business, Treasurer Caprio entertained a motion to adjourn the meeting. Mr.

**Giudici moved, Mr. Treat seconded and the 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.**

**VOTED: To adjourn the meeting.**

**There being no further business, the meeting was adjourned at 11:30 a.m.**

**Respectfully submitted,**

**Frank T. Caprio**

**General Treasurer**