

State of Rhode Island and Providence Plantations

STATE INVESTMENT COMMISSION

Regular Meeting May 28, 2008

A State Investment Commission (SIC) meeting was held in Room 135, State House, Providence, Rhode Island on Wednesday, May 28, 2008. 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, Ms. Marcia Reback, Mr. Andrew Reilly, Mr. John Treat, and General Treasurer Frank T. Caprio. Also present were: Mr. Kenneth E. Goodreau, Deputy General Treasurer for Finance; Mr. Paul Campellone, of Adler Pollock & Sheehan, Legal Counsel to the Commission; Mr. William Bensus, General Consultant to the Commission; Ms. Michelle Davidson of the Pacific Corporate Group, Alternative Investments Consultant to the Commission; Ms. Lisa Tyrrell of the State Street Corporation; and other members of the Treasurer's staff. Mr. Robert Gaudreau was not present. Mr. Costello and Dr. McKenna left at 11:00 a.m.

State Investment Commission Minutes. The Treasurer entertained a motion for approval of the minutes. Ms. Reback moved, Dr. McKenna seconded and the following motion was passed. 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 April 23, 2008 regular meeting.

Manager Continuation Policy Analysis Fourth Quarter –Wilshire Associates. Mr. Bensus stated that the U.S. Equity Portfolio structure and the U.S. Equity Managers are performing in line with expectations. He recommended the Commission retain all U.S. Equity Managers: NorthPointe, PIMCO, SSgA S&P 500 Index, Wellington Small Core, and Wellington Technical. Mr. Bensus went on to explain that the Commission should re-visit the idea of adding alpha transfer capabilities within the U.S. equity investment structure.

Mr. Bensus remarked that within the non-U.S. equity sector, The Boston Company has been on the watch list for many months. In April they were approximately 26 basis points above the benchmark, but lost their relative performance gains in May. Mr. Bensus recommended conducting a non-U.S. investment structure analysis, considering termination of The Boston Company, and adding a passive anchor to the non-U.S. equity portfolio. A passive non-U.S. equity index allocation will reduce the risk of under-performance, which may also reduce the probability of out-performance. Goldman Sachs under-performed slightly for the quarter, but has performed well in the past. Mondrian was once again the top performer in the

non-U.S. equity sector.

The Fixed Income investment structure within the portfolio is solid. Brown Brothers Harriman (TIPS) has performed extremely well. Pyramis Global Advisors, Brown Brothers Harriman (Core Fixed Income), and Taplin, Canida & Habacht have been negatively affected by lack of bids for securities. As the market recovers and the bidding improves, the pricing will be reflected in the portfolio, which should recoup some of these losses. Mr. Bensus recommended retaining all of the current Fixed Income Managers. Treasurer Caprio asked Mr. Bensus to compare the March 31, 2008 Quarterly Report sent to the Commission by Pyramis Global Advisors to the chart labeled "Excess Return versus Lehman Mortgage Index" in Wilshire's report. The Treasurer remarked that during the last three years Pyramis was down 1.14% against the benchmark amid favorable market conditions. Mr. Bensus stated that from June 2007 through May 2008 they lost all the gains they had achieved. Most recently, 1.6% was lost during the March quarter. Prior to June 2007 they were in line with expectations. Mr. Bensus then recommended the Commission wait for the portfolio performance to recover, as this is a seasoned investment which is not principle impaired. Treasurer Caprio observed that the Lehman benchmark is up 8% for the year, but Pyramis is only up 4%. He then noted that other Fixed Income Managers were facing the same market issues as Pyramis, but were able to meet or exceed the benchmark. The Treasurer suggested that representatives from Pyramis appear before the Commission to

discuss these issues.

Ms. Reback asked about MacKay Shields performance. Mr. Bensusur replied that MacKay Shields has been on a watch list regarding management personnel changes for the last two years. They have been adding to their Staff and retaining Senior Staff Members. Mr. Bensusur will recommend that they be taken off the watch list. Over the long term, MacKay Shields has done an excellent job, earning 2% net of fees over the benchmark.

Performance Attributions First Quarter 2008 - Wilshire Associates. Mr. Bensusur observed that the absolute rate of return was down 6.3% for the first quarter. The policy benchmark was down 5.8% for the same period. U.S. Equity lost about 26 basis points and non-U.S. Equity lost about 5 basis points. Alternative Investments continue to perform well and added about 9 basis points. Real Estate was down about 9 basis points, Fixed Income was down 26 basis points and Cash picked up about 4 basis points.

Mr. Costello asked what level of confidence Mr. Bensusur has in pricing challenges in a three month period in regard to performance of Alternatives, Real Estate, and Fixed Income. Mr. Bensusur replied that it would be difficult to assess performance in these areas in such a short period of time. He stated that there is a lag time and a huge residual when calculating the attributions during a three or four month period. However, it may be more feasible to predict

performance of attributions by linking the quarters together over a twelve month period.

Over the past five years the fund return has been 13.78%, which exceeds the total fund benchmark by 40 basis points, net of fees. Mr. Bensur advised the Commission to continue to stay on asset allocation targets and explore new investment ideas to add value to the portfolio in areas such as U.S. equity. He noted it would also be helpful to re-structure the non-U.S. equity portion of the portfolio.

Capital Market Review – Wilshire Associates. Mr. Bensur began his review by stating that oil and commodities will see more volatility in the next two months. He referred to the DJ-AIG Commodities, which is a diversified investment including metals, agriculture, and energy. Last year this asset allocation was up 16.2% against the benchmark, the first quarter it was up 9.5% and year to date through May 23rd it was up 18.7%. Real Estate benchmarks, both U.S. and Global, were down 17% last year but have recovered slightly.

Through the close of business on May 27, 2008, the Wilshire 5000 was down 4.2%, Emerging Markets were down 2.9%, Developed Markets were down 2.7%, the Total Market was down 2.7%, and the Lehman Aggregate was up 1.6%. The majority of ERSRI's assets are in public equity which is down approximately 3% across the board, making it very difficult to generate returns at this time.

Treasurer Caprio introduced Ms. Davidson from PCG who presented two Funds for investment consideration to the Commission.

Alternative Investments Consultant PCG – Apollo Investment Fund VII. Ms. Davidson stated that Apollo Fund VII will be pursuing private equity and equity-related opportunities as well as debt-security investments. Apollo is seeking capital commitments of approximately \$15 billion and has already closed on \$13 billion. Apollo Investments has achieved net returns of approximately 29% in six prior funds through various economic cycles over an eighteen year period. Their loss ratios are very low indicating that returns are achieved without taking on excessive risk. The Fund will focus on classic buyouts, corporate partner buyouts, and distressed investments across a broad range of industries, predominantly in North America. Approximately \$200 million to \$1.5 billion of equity will be invested in twenty to twenty five companies. The final closing is expected to occur sometime in mid/late 2008. The General Partner and its affiliates will make a commitment of at least \$250 million to the Fund, equating to approximately 1.67% of the anticipated Fund commitments. The majority of this commitment will be in cash, but a percentage may be funded by a reduction in ERSRI's management fee. Ms. Davidson commented that her review of the General Partner and proposed Fund indicates that the potential returns justify the risks associated with investment in Fund VII.

Ms. Davidson introduced Eric Zinterhofer, Senior Partner, and

Stephanie Drescher, Partner, from Apollo Investments. Mr. Zinterhofer gave a brief history of the Firm stating it was founded in 1990 and has managed \$40 billion since inception with gross returns of 41% and 29% net. They have an integrated platform between Private Equity and Capital Markets and a Staff with significant credit expertise, which enhances their ability to make profitable buyout investments. The Founding Partners have been together for twenty years and the Senior Partners have worked together thirteen years. There is an extremely long apprenticeship period because the professionals at Apollo are expected to be adept in distressed buyouts as well as traditional leverage buyouts before becoming a Partner. This expertise has made Apollo Investments successful across all economic cycles. Due to the current market environment, Apollo Fund VII has shifted its focus to distressed opportunities. As the economy begins to recover, Fund VII will move toward traditional leveraged buyouts. With the exception of Harrah's Entertainment, Apollo does not partner with other firms to avoid double exposure to large buyouts of multiple funds.

ERSRI is currently invested in Fund VI. Ms. Drescher gave a brief overview of the performance of Fund VI stating it is fully committed. The IRR currently is 58% gross and 42% net. The Fund has realized an increase in value of \$1.5 billion above cost since inception. The portfolio represents a number of exclusive situations and many strategic platforms across industries well known to Apollo. Fund VI has distributed \$1.3 billion or 27% of invested and committed capital

as of December 30, 2007. Mr. Reilly asked how much of the portfolio has been realized. Ms. Drescher replied the realized portion of the portfolio is \$1.3 billion. Treasurer Caprio asked how often the estimated fair value of the Fund is updated. Ms. Drescher replied it is updated quarterly and the value stated in this presentation is as of December 31, 2007. Ms. Drescher noted that from December 2007 to March 2008 the net returns were down slightly, to approximately \$1.1 billion. The IRR continues to be in excess of 30% and the portfolio recovered slightly in April.

Treasurer Caprio mentioned the estimated fair value of Harrah's Entertainment in this report is not a reflection of the value as of April 2008. Mr. Zinterhofer concurred and there was a discussion regarding the past, present, and future strategy of this investment.

Mr. Reilly inquired when there would be more realized proceeds in debt securities. Mr. Zinterhofer explained that there are many different categories within debt securities. He anticipates returns will be realized in all categories within three years.

Mr. Zinterhofer ended his presentation by referring to updates and case studies for Fund VI. He thanked the Commission and offered to answer any questions the Commission may have regarding Apollo Investments in the future.

Treasurer Caprio thanked Ms. Drescher and Mr. Zinterhofer for their

presentation. He then entertained a motion for investment in Apollo Investment Fund VII. Ms. Reback moved, Mr. Reilly and Mr. Giudici seconded and the following motion was passed. 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 accept PCG's recommendation that the SIC commit up to \$25 million in Apollo Investment Fund VII, contingent upon the conditions documented in PCG's Investment Memorandum dated May 2, 2008, and upon satisfactory review and negotiation of investment and legal documents with no material changes to the opportunity as presented.

Treasurer Caprio advised the Commission that CVC European Equity Partners was not able to attend this Meeting. Since there are no immediate time constraints in regard to the closing date of Fund V, the Treasurer entertained a motion to continue the CVC European Equity Fund V discussion at the next SIC Meeting. Dr McKenna moved, Mr. Treat and Mr. Giudici seconded and the following motion was passed. 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 continue the discussion regarding investment in CVC European Equity Partners V during the June 25, 2008 SIC Meeting.

Alternative Investments Consultant PCG – Constellation Ventures III.

Ms. Davidson stated that Constellation Ventures III is being formed to make stage diversified investments in digital media, communications and information technology sub-sectors. The Fund is targeting \$250 million in commitments, with a hard cap of \$350 million. Four initial investments, totaling \$12.4 million, have been made as of January 31, 2008. Constellation will build a portfolio of approximately twenty to twenty five companies with initial investment sizes ranging from \$5 million to \$10 million. The Fund will invest primarily in the U.S.; however, up to 33.3% may be invested outside North America, with a particular focus on Europe. The Fund has had two closings totaling \$120 million and expects to hold a final closing by June 30, 2008. Since inception, the General Partners have established a strategic partnership with Bear Sterns. JP Morgan is in the process of acquiring Bear Sterns and has accepted full responsibility for Bear Stern's capital commitment to the Fund, which is approximately \$50 million. The investment professionals of the Fund will commit \$19.3 million. Ms. Davidson noted that a commitment to Fund III is complimentary to ERSRI's current Venture Capital Portfolio.

Ms. Davidson introduced Clifford Friedman, Founding Partner of Constellation Ventures. Mr. Friedman explained that Constellation Ventures III has invested, committed, and reserved \$73 million through May 2008. Since 1998, Constellation has invested approximately \$365 million in forty portfolio companies across two Funds. As of December 31, 2007, the Firm has realized \$298 million

with an unrealized value of \$309 million. They have generated a combined gross IRR and gross total value multiple of 12.7% and 1.7x, respectively. The net IRR and net total value multiple are 7.9% and 1.4x, respectively.

Fund II has returned nearly 100% of invested capital, which is driving the establishment of Fund III. Mr. Friedman went on to review investments made in Fund II, explaining the high level of expertise and the consistent and thematic strategic planning done by the investment professionals at Constellation Ventures.

Constellation Ventures believes the convergence of media, communications, and technology will present compelling and unique investment opportunities during the next five to seven years. Constellation Venture Fund III has five investments to date based on this concept. Mr. Friedman explained the technology and current performance of each investment. The Investment Partners have a large ownership stake in all deals, which is approximately 8% of capital. Mr. Costello remarked that the Partners are contributing a significant amount of capital knowing there is a risk of substantial write-offs. He asked Mr. Friedman what he is doing to mitigate this risk. Mr. Friedman noted that some investments in Fund II did not perform well, such as Verance Corporation. To mitigate risk and to avoid under performance in the future, Constellation now does long stage platform investing using a broader portfolio. He concluded that he believes the 2000 Portfolio will be about 2.2x cash on cash at

close, and Fund III should have much better returns than Fund II.

Treasurer Caprio thanked Mr. Friedman and then entertained a motion for investment in Constellation Ventures Fund III. Mr. Costello moved, Ms. Gallogly seconded and the following motion was passed. 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 accept PCG's recommendation that the SIC commit up to \$15 million in Constellation Ventures Fund III, contingent upon the conditions documented in PCG's Investment Memorandum dated May 2,2008, and upon satisfactory review and negotiation of investment and legal documents with no material changes to the opportunity as presented.

Legal Counsel Report. Mr. Paul Campellone, of Adler Pollock & Sheehan, Legal Counsel to the Commission, indicated there were no legal developments for the month.

Deputy Treasurer for Finance report. Mr. Goodreau noted the Portfolio is doing relatively well, despite the current volatility. The Fixed Income sector continues to under perform. The portfolio is under weight in the High Yield sector which has been a positive in this market environment. The Wellington Portfolio has out performed

the benchmark by about 13% in the last six months. The Boston Company, who has been routinely under performing, was 25 basis points above their benchmark for the month.

Treasurer's Report. Treasurer Caprio advised the Commission that the Investment Sub-Committee has completed interviewing all applicants for the position of General Consultant. A Sub-Committee Meeting will be scheduled to discuss the results of the interviews, with intentions of reporting the findings to the Commission during the June SIC Meeting.

The Treasurer expressed the importance of the Treasury Internship Program and introduced two members who are currently participating: Janine Kwoh, who attends Brown University and Charles Moroni, who attends Skidmore College. They will be attending meetings and have been doing research regarding our Investment Portfolio.

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

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

VOTED: To adjourn the meeting.

There being no further business, the meeting was adjourned at 11:07 a.m.

Respectfully submitted,

Frank T. Caprio

General Treasurer