

State of Rhode Island and Providence Plantations

STATE INVESTMENT COMMISSION

Regular Meeting July 23, 2008

A State Investment Commission (SIC) meeting was held in Room 135, State House, Providence, Rhode Island on Wednesday, July 23, 2008. The Treasurer called the meeting to order at 9:12 a.m.

Membership Roll Call. Present were: Mr. Michael Costello, Mr. Robert Giudici, Mr. Thomas Mullaney *, Ms. Marcia Reback, Mr. John Treat, and General Treasurer Frank T. Caprio. Also present were: Mr. Kenneth E. Goodreau, Deputy General Treasurer for Finance; Ms. Sarah Dowling, of Adler Pollock & Sheehan and Mr. Joseph Rodio, of Rodio & Ursillo, Legal Counsel to the Commission; Mr. Allen Emkin, General Policy Consultant to the Commission; Mr. Scott Reinig of the Pacific Corporate Group, Alternative Investments Consultant to the Commission; Mr. Anthony Frammartino of The Townsend Group, Real Estate Consultant to the Commission; Mr. Frank Karpiski, Executive Director of Retirement; and other members of the Treasurer's staff. Mr. Drew Reilly arrived at 9:10 a.m. and Dr. Robert McKenna arrived at 9:30 a.m.

*** Designated as Ms. Rosemary Booth Gallogly's voting proxy for the July 23, 2008 Meeting**

State Investment Commission Minutes. The Treasurer entertained a motion for approval of the minutes. Mr. Giudici moved, Mr. Gaudreau seconded and the following motion was passed. The following members voted in favor: Mr. Costello, Mr. Gaudreau, Mr. Giudici, Mr. Mullaney, Ms. Reback, Mr. Treat, and Treasurer Caprio.

VOTED: To approve the Minutes of the June 25, 2008 regular meeting.

Capital Market Review – Pension Consulting Alliance. The Treasurer noted that although the legal documents have not been finalized between the Commission and Pension Consulting Alliance, Mr. Emkin chose to participate as General Policy Consultant at this SIC Meeting.

He thanked Mr. Emkin for his participation under these circumstances.

Mr. Emkin thanked the Commission for the opportunity and privilege of working with them. He introduced his associate, Mr. John Burns, who has been hired specifically to accommodate the needs of the Commission. He has twenty-five years of industry experience and is based in New York. Mr. Emkin explained that each new relationship has its own challenges and needs. He encourages the input of each Member so he can provide information analysis to help the Commission make successful investment decisions.

Mr. Emkin went on to review the current market conditions. He stated

that on a long term basis the portfolio has done well. He stated that it is dangerous to always be reacting to the market. From his perspective, there is a need for a high conviction rate before taking an action and he feels this market environment allows for this type of investment strategy. He remarked that in comparison to other portfolios, we are at an advantage because we do not have a great need for liquidity. Since we can be a provider of liquidity the portfolio should earn a higher rate of return on investments. Treasurer Caprio asked for an example of these types of investments. Mr. Emkin referred to PIMCO, who manages many of his clients fixed income assets. PIMCO put together a fund to buy about \$3 billion of very high quality debt assets from Citibank at about a 15% discount. Mr. Emkin recommended that his client invest in this relatively liquid asset for a period of three years. PIMCO projects a return more than double that of a traditional bond portfolio. Another example would be purchasing debt in distressed high quality real estate with equity upon purchase while gaining an extraordinary rate of return.

Mr. Emkin remarked that the equity portion of ERSRI's portfolio, which is the largest asset class, has decreased dramatically. Bonds are up slightly, but the real estate and private equity portions of the portfolio have appreciated. This is resulting in an increase of capital calls and fewer distributions. Mr. Emkin believes the broad commercial real estate market will depreciate 10-15%. It will be extremely challenging in next 3-5 years to achieve actuarial rates of return. There are two reasons for this: the yield in the bond market is

still low by historical standards and very few analysts are bullish on domestic or international equity markets. It is important to take this information and turn it into proactive policies that take advantage of the conditions of the capital markets.

Mr. Giudici asked Mr. Emkin to discuss industry performance in relation to future market conditions. Mr. Emkin replied that inflation and energy costs will impact all industry sectors. It is his belief that inflation will continue to increase, which will take away purchasing power. Increasing energy costs will also continue to negatively affect industries that cannot transfer these costs onto the consumer, such as the airline industry. The financial services industry has not yet bottomed out. There will be more bank failures and the housing market will continue to decline dramatically.

Alternative Investments Consultant – AEW Core Property Fund. Mr. Frammartino of The Townsend Group noted that real estate performance has been strong over the past year relative to other asset classes. There has been a moderating in returns, but our portfolio return over the last year was approximately 13%. The target allocation for the core portfolio is 65% of our real estate asset class. A commitment to AEW Core Property Fund (ACF) of \$35 million will bring the portfolio up to this target. AEW is one of the world's largest real estate management companies, which is based in Boston with affiliated operations in Europe and Asia. There are over two hundred employees worldwide and they manage in excess of \$20 billion in

private and public real estate. AEW seeks to raise seed capital from a select group of investors exclusively through The Townsend Group. ACF is a start up fund which was formed to provide an additional investment alternative to the existing Open-End Core Funds. AEW will substantially reduce the base asset management fee for commitments received within twelve months to 50 basis points on the initial commitment amount, inclusive of future appreciation in value and reinvesting of operating dividends.

Mr. Frammartino went on to discuss our current investment in RREEF America REIT II. This investment is currently on “hold status” due to underperformance. There has been a significant rate of turnover among the senior staff which has added to the current risk. He stated the Commission may want to consider exiting this investment. The Treasurer asked Mr. Frammartino to work with the Commission to structure a timeline and recommendation regarding RREEF America REIT II, so it can be discussed at a future SIC Meeting. Mr. Goodreau stated there would not be an SIC Meeting in August, which will prolong the process of divestiture in RREEF America REIT II. If The Townsend Group recommends divestiture in writing prior to the September meeting, the Treasurer entertained a motion to allow the Commission to approve the exit at that time. Ms. Reback requested the Staff and Real Estate Consultant give the Commission Members all necessary information in advance of the September meeting, so the members will be prepared to make a decision on September 24, 2008. The Treasurer agreed with Ms. Reback’s recommendation and

he entertained an amendment to the motion. Ms. Reback moved, Dr. McKenna seconded and the following motion was passed. The following members voted in favor: Mr. Costello, Mr. Gaudreau, Mr. Giudici, Dr. McKenna, Mr. Mullaney, Ms. Reback, Mr. Reilly, Mr. Treat, and Treasurer Caprio.

VOTED: To allow The Townsend Group to notify the Commission in writing regarding a possible decision to exit RREEF America REIT II prior to the September 2008 SIC Meeting; The Townsend Group will provide all necessary information to prepare the Commission to vote regarding the possible divestiture on September 24, 2008.

The Treasurer asked the representatives from AEW Capital Management to proceed with their presentation. Mr. Steven Corkin, Head of Client Service, began by introducing his co-workers: Mr. Robert Plumb, Head of Acquisitions and Mr. Jonathan Martin, Assistant Portfolio Manager. Mr. Corkin noted that AEW Capital Management's core investments have outperformed the National Council of Real Estate Investment Fiduciaries - Open-end Diversified Core Equity Index (NCREIF-ODCE) by 600 basis points over five years and 250 basis points over ten years. They currently have \$7.5 billion in core assets under management. They are heavily focused on research, which allows the team at AEW to anticipate changes in market conditions and to assess market risks. They are active and experienced in virtually all property types.

Mr. Corkin asked Mr. Martin to address the Commission regarding the investment strategy of AEW Core Property Fund. Mr. Martin stated the Fund currently has \$860 million of committed capital and has invested \$350 million since the first closing in 2007. The target return of the Fund is to exceed the National Fund Index – Open-end Diversified Core Equity (NFI-ODCE). AEW Core Property Fund will focus on office, retail, multifamily, and industrial property types. AEW will seek well-leased assets with above average NOI growth potential from a combination of rolling below market in-place leases and/or strong market fundamentals. They will be primarily stabilized, institutional quality assets throughout the U.S., where markets meet key research driven principles and AEW has an extensive operating history. Initial acquisition costs will be at or below today's replacement cost with a careful evaluation of land basis. These properties will provide preservation of capital and stable income, which is the overall goal of the Fund. Each member of the investment team has an average of twenty years of real estate experience. They are seasoned in acquisition and asset management. The team is supplemented by an extensive platform of shared resources, including the Investment Committee. Mr. Martin ended his presentation by commenting that he feels this is a great opportunity for the Commission. He asked Mr. Plumb to speak regarding the outlook for 2008.

Mr. Plumb went on to explain that this is an opportune time to be in core market

space. There is an abundance of de-leveraging in the market. AEW has been slow and methodical while investing capital, which has resulted in negotiation of very favorable pricing. He stated that replacement costs have been skyrocketing in the current market conditions, and it is very important to buy at or under these costs to have a profitable investment. Mr. Plumb went on to give a brief review of current and pending assets within the Fund.

Treasurer Caprio asked what process is used by AEW to market property when a tenant leaves. Mr. Plumb explained that the Asset Management Group, Accounting Group, and Acquisitions Group all work together when they underwrite a property. They develop a business plan regarding renovations and proposed changes to the property. Every year these Groups go back to the underwriting phase of the business plan process and review each lease to determine how the plan has progressed and what to do with the property going forward. Mr. Corkin commented that AEW does not handle the property management, but they have a dedicated asset manager assigned to each property along with an accountant and an analyst. This group meets with the property manager each month to be sure the underwriting plan is being followed and to make adjustments according to market conditions.

The Treasurer entertained a motion to accept The Townsend Group's recommendation that the SIC commit up to \$35 million in AEW Core Property Fund. Dr. McKenna moved, Ms. Reback, Mr. Treat, and Mr.

Giudici seconded and the following motion was passed. The following members voted in favor: Mr. Costello, Mr. Gaudreau, Mr. Giudici, Dr. McKenna, Mr. Mullaney, Ms. Reback, Mr. Reilly, Mr. Treat, and Treasurer Caprio.

VOTED: To accept The Townsend Group's recommendation that the SIC commit up to \$35 million in AEW Core Property Fund, contingent upon satisfactory review and negotiation of investment and legal documents with no material changes to the opportunity as presented.

Legal Counsel Report. Treasurer Caprio mentioned that Mr. Rodio, of Rodio & Ursillo Ltd, has submitted a memo to the staff stating that legal contract drafts have been submitted to Pension Consulting Alliance, Russell Investments, and Brockhouse & Cooper, who have been chosen to represent the State Investment Commission as consultants with varying roles of responsibility. As stated in the motion during the June 25, 2008 SIC Meeting, the fee structure will be no higher than the fee structure in place with the existing consultant and there will be more flexibility to exit or renew the contracts. The Treasurer indicated that he does not foresee any problems with the negotiations and the contracts should be signed soon.

Ms. Dowling, of Adler Pollock & Sheehan, announced that all pertinent paperwork for CVC European Equity Partners V has been completed and the closing will be Monday July 28, 2008. The

investment in Constellation Ventures Fund III has not closed, as the requested addition of a no-fault termination clause to the agreement has not been completed. Ms. Dowling is reviewing the recommendation from PCG to amend the agreements of Nautic Partners VII and SKM Equity Fund II.

Deputy Treasurer for Finance report. The Treasurer announced that Mr. Goodreau's title has been changed to Chief Investment Officer, which is consistent with colleagues who are in similar investment management positions. Mr. Goodreau thanked the Commission for their patience and diligence during the RFP selection process. He expressed confidence that the structure the Treasurer has put in place will result in more efficiency within the portfolio, which should ultimately produce higher returns. He will be traveling in August to Portland, Oregon to meet with the key representatives from Pension Consulting Alliance and then on to Tacoma, Washington to meet with the representatives from Russell Investments. He offered to compile information from the respective Consultants regarding any questions the Commission Members may have.

Mr. Goodreau remarked that the stock/bond differential is at a 68 year extreme. There has not been a period since 1940 where bonds have outperformed stocks to this extent. Stocks are not going up and bonds are not a viable investment alternative due to a flight to quality.

This situation should eventually lead to an incredible investment opportunity, which will be enhanced due to the liquidity within the

portfolio. Mr. Goodreau gave a brief review of market performance for the month of June. He stated that the overall market did not perform well in June. The ERSRI portfolio posted a loss of 4.8% against the policy index of -5.62%. The S&P was down 8.4%, SSgA Core picked up 3.5% for the year and has now gained positive alpha, while exceeding the benchmark by 1.2%, Wellington Technical Equity was down 3.4% but picked up 500 basis points over market and is positive for the year. Goldman Sachs' performance has improved, achieving positive alpha over the year. Due to a high concentration of cash, Fixed Income picked up about 20 to 30 basis points over the Lehman AGG. The total portfolio picked up 78 basis points of alpha over the month, which puts the total portfolio for the calendar year in positive alpha. Mr. Goodreau cautioned that Private Equity reevaluations have not been processed through the accounting cycle, so this may have an effect on returns for the year.

Mr. Costello stated that both Mr. Goodreau and Mr. Emkin mentioned the benefits of being opportunistic in these types of markets. He asked if we will have the ability to capture these opportunities without being bogged down by the current RFP Process, which creates time lags that prevent the Commission from capitalizing on these new opportunities.

Treasurer's Report. The Treasurer replied that this issue was part of his report. To achieve this, the Treasurer mentioned that it is Mr. Goodreau's intention to work very closely with our new consultants,

drawing on their strategic relationships with world class managers such as PIMCO. He added that he believes it is asset allocation, as opposed to choice of managers, which will result in higher returns. When Mr. Goodreau has completed his site visits to PCA and Russell Investments, the Treasurer will put into place a process to hasten the timeline for changes in asset allocations and an investment guideline process for update and review of investments. He invited all of the Commission Members to participate in the process. He will keep the Commission apprised of future updates.

The Treasurer expressed his gratitude to the summer interns, noting that their work has been outstanding. He then asked the interns to introduce themselves: Kartik Naram, Janine Kwoh, Courtney Silva, Scott Hefferman, Ryan Forman, Nasha Patel, and Charles Moroni.

The Treasurer commented that there will be publicity within the next week regarding ERSRI's portfolio performance for fiscal year 2008. The figure is -4.84%, which is in line with other large public funds within the U.S. Our goal will be to maximize returns going forward.

The Treasurer stated that there will not be an SIC Meeting in the month of August. Treasurer Caprio then entertained a motion to revert to past practice and not have a regularly scheduled SIC Meeting for the month of August, but to stand ready should there be a need for a meeting. The next regularly scheduled meeting will be September 24, 2008. Mr. Treat moved, Dr. McKenna seconded and

the following motion was passed. The following members voted in favor: Mr. Costello, Mr. Gaudreau, Mr. Giudici, Dr. McKenna, Mr. Mullaney, Ms. Reback, Mr. Reilly, Mr. Treat, and Treasurer Caprio.

VOTED: To revert to past practice and not have a regularly scheduled SIC Meeting for the month of August, but to stand ready should there be a need for a Meeting. The next regularly scheduled Meeting will be September 24, 2008.

New Business. There being no further new business, the Treasurer entertained a motion to adjourn. The following members voted in favor: Ms. Reback moved, Dr. McKenna seconded and the following motion was passed. Mr. Costello, Mr. Gaudreau, Mr. Giudici, Dr. McKenna, Mr. Mullaney, Ms. Reback, Mr. Reilly, Mr. Treat, and Treasurer Caprio.

VOTED: To adjourn the meeting.

There being no further business, the meeting was adjourned at 10:42 a.m.

Respectfully submitted,

Frank T. Caprio

General Treasurer