

State of Rhode Island and Providence Plantations

STATE INVESTMENT COMMISSION

Regular Meeting October 22, 2008

A State Investment Commission (SIC) meeting was held in Room 135, State House, Providence, Rhode Island on Wednesday, October 22, 2008. The Treasurer called the meeting to order at 9:08 a.m.

Membership Roll Call. Present were: Ms. Rosemary Booth Gallogly, Mr. Robert Gaudreau, Ms. Marcia Reback, Mr. John Treat, and General Treasurer Frank T. Caprio. Also present were: Mr. Kenneth E. Goodreau, Chief Investment Officer; Ms. Sarah Dowling, of Adler Pollock & Sheehan, Legal Counsel to the Commission; Mr. Allan Emkin and Mr. John Burns of Pension Consulting Alliance, General Policy Consultants to the Commission; Ms. Michelle Davidson of the Pacific Corporate Group, Alternative Investments Consultant to the Commission; Ms. Laura Callahan of State Street Corporation, and other members of the Treasurer's staff. Dr. Robert McKenna arrived at 9:15 a.m. Mr. Robert Guidici and Mr. Andrew Reilly were not present.

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

Ms. Reback, Mr. Treat, and Treasurer Caprio.

VOTED: To approve the Minutes of the September 24, 2008 regular meeting.

Treasurer's Report. Treasurer Caprio noted that he would like to discuss three items prior to the Capital Market Trends Report. He expressed the need for the SIC to begin holding bi-monthly meetings due to the extreme volatility of the market. During this time, decisions regarding the portfolio may have to be made more often than once per month. He asked for the Commission's support regarding additional meetings. The meetings will be held monthly once the market environment becomes less volatile, and the SIC has accomplished all the objectives.

The Treasurer entertained a motion to hold bi-monthly SIC Meetings, until such time as they are no longer necessary. Ms. Reback moved, Mr. Costello seconded and the following motion was passed. The following members voted in favor: Mr. Costello, Ms. Gallogly, Mr. Gaudreau, Ms. Reback, Mr. Treat, and Treasurer Caprio.

VOTED: To hold bi-monthly SIC Meetings, until such time as they are no longer necessary.

The next item the Treasurer covered was the recent publicity related to an investment in The Reserve Fund. The Reserve Fund is the

oldest Money Market Fund in the U.S., and it has always been considered a very safe investment. Two of the largest series within The Reserve Fund are The Prime Fund and the U.S. Government Fund. ERSRI has \$62 million invested in the U.S. Government Fund. A portion of The Prime Fund's short term investments were with Lehman Brothers Holdings. Lehman Brothers filed a petition for bankruptcy on September 15, 2008. The value of the debt securities issued by Lehman Brothers (face value \$785 million) and held by the Primary Fund was valued at zero effective September 16, 2008 and the NAV of the Primary Fund dropped to \$0.97 per share. This event caused unprecedented requests for redemption or transfer of funds. The SEC issued an order to suspend all rights of redemption for both The Primary Fund and the U.S. Government Fund on September 22, 2008. The SEC order will remain in effect until sufficient liquidity returns to the market. The Treasurer traveled to New York and met with the CEO of The Reserve to discuss the situation approximately two weeks ago. Since then, a team has been formed, comprised of ERSRI and several of the largest investors in the fund. This team has been having regular discussions with the SEC and the U.S. Treasury. In the meantime, measures have been taken to ensure the short term cash flow is not affected.

Ms. Reback noted that the SIC was not alerted by the staff of when this situation arose, and asked to be notified in the future. The Treasurer assured Ms. Reback that there will be communication regarding similar issues in the future.

Treasurer Caprio stated that one of our Money Managers, Taplin, Canida & Habacht, is being acquired by another fund. The documents regarding this transaction have been received and are being reviewed at this time.

Capital Market Trends – Pension Consulting Alliance. Mr. Burns gave an overview of the significant equity market declines over the last sixty years. He observed that the market recovered within a year during each of these periods. Mr. Burns observed there is a severe flight to quality. He stated that the calendar week ending October 10, 2008, experienced the worst market performance since 1928. Financial stocks are in an extreme decline, causing the banks to stop lending to each other, as well as corporations, and individuals. This could result in more layoffs.

Mr. Emkin went on to explain that Credit Derivative Swaps (CDS) are based upon pricing of individual corporate bonds. He noted that the market is unregulated, and no one knows exactly how large this market is. If there is a default somewhere within this market, there will be more dislocation within the credit markets, which will have an impact on the stock market. The major exchanges are trying to create a clearing house for CDS, and the SEC is monitoring their efforts. Mr. Emkin concluded by stating that CDS are part of the challenge that the policymakers around the globe are facing regarding the credit markets. Ms. Booth asked if any of our Money Managers have CDS

investments in our portfolio. Mr. Emkin replied he will look into it, but to the best of his knowledge, there are none in the portfolio. Mr. Dingley asked if Lehman Brothers Holdings were participating in the CDS market. Mr. Emkin confirmed they were.

Mr. Burns observed that credit spreads have widened in every market with the exception of the Emerging Market Sovereign Bonds. Global financial players have more confidence in the markets in Korea and Brazil than in major markets around the world.

Mr. Burns announced that letters are being sent to all of ERSRI's Money Managers asking them to be proactive and advise the SIC of any new opportunities that may be advantageous in this market environment. Mr. Burns will keep the Commission apprised of any developments. Mr. Emkin added dislocations create opportunity, but you have to have the ability to act when the opportunity presents itself. This is the one of the topics Mr. Emkin and Mr. Burns will cover during the additional SIC Meetings.

Mr. Costello asked Mr. Emkin if he thinks this market recovery will be different than any time in past history. Mr. Emkin replied yes. He noted that all market risk models done in the last ten years have been understated by 50% to 75%. There has never been a global reaction where global central banks are coordinating efforts to create liquidity to free up the market.

Mr. Emkin explained that the objective is to improve the portfolio's long-term performance and funding ratio. This will be accomplished through focusing on the investment policy, which will include a review of all existing investment policy documentation. PCA will be focusing on improving fund management, as well as reevaluation of all fund policies and procedures. Due to the extreme market conditions, Mr. Emkin emphasized the importance of communicating this information to the SIC in a timely manner, as it is crucial to the portfolio to control costs.

Mr. Emkin announced the topics of future meetings will be asset allocation, rebalancing policy, risk management, equity portfolio structural review, fixed income portfolio structural review, and securities lending program overview. This information will help the Commission make positive decisions and give PCA direction toward the goal of improving performance. This process normally takes PCA eighteen to twenty four months, but due to the current volatility, it will be accelerated and completed in six months.

Mr. Goodreau told the SIC that he is always available for any questions or concerns that they may have. He went on to report that there were some positives within the last year. Last March when credit spreads were very tight, the SIC voted to exit Shankman Capital Management. This proactive decision removed high yield risk from the portfolio. Credit spreads were very tight last year when ERSRI exited Shankman Capital Management. All ERSRI's asset classes are

now liquid and transparent.

Alternative Investments Consultant PCG . Ms. Davidson stated there would not be a private equity presentation. Mr. Costello asked Ms. Davidson to explain the twelve to eighteen month outlook in private equity. Ms. Davidson replied that the focus is on strategies that increase liquidity.

Ms. Gallogly asked if there has been an increase in the amount of capital calls we are receiving because of the decrease in liquidity. Ms. Davidson responded that capital calls are increasing because investment activity is continuing, but ERSRI is not seeing corresponding distributions. She went on to explain that this is a good time to invest in funds that are able to get financing, because valuations are lower creating good investment opportunities.

Treasurer Caprio explained that we will continue to monitor the value of the portfolio and asset allocation in regard to private equity investments. Once there is positive movement in the private equity allocation, we will resume pursuing new investment opportunities.

Alliance Bernstein – CollegBoundfund Investment Review & Market Timing Settlement. Treasurer Caprio announced that representatives from Alliance Bernstein would be giving a review of the CollegeBoundfund. Jennifer DeLong, Director, Education Solutions

Group, began her review by introducing the representatives: Mark Anderson, VP Legal Counsel and Compliance and Tom Fontaine, Director of Research and Investment Design. Ms. DeLong stated that total assets for the fund are \$7.020 billion, which includes \$206 million in assets from R.I. The CollegeBoundfund has a 14% market share. Performance has been highly ranked for the past three years, maintaining a leadership position in both the Direct-Sold Program and the Advisor-Sold Program.

Ms. DeLong turned the presentation over to Mr. Anderson. Mr. Anderson explained that Alliance Bernstein settled litigation with the SEC and the N.Y. Attorney General on December 18, 2003, for allowing improper market timing practices in ten of the retail mutual funds, many of which were included in the CollegeBoundfund. Alliance Bernstein has established a \$250 million fund to compensate shareholders. The total funds for distribution are \$321 million, including settlements of Alliance Bernstein Officers and Market Timer, Daniel Calugar. Distributions will begin in early 2009 and will consist of four waves of checks. The RIHEST/CollegeBoundfund will receive approximately \$8.5 million in early May, 2009.

Mr. Dingley stated that the settlement distribution plan has been reviewed very closely by outside counsel for RIHEAA, as well as by Ms. Dowling, SIC legal counsel. The distribution detail has been worked out in regard to the CollegeBoundfund, and proceeds will be deposited in each investor's account. There are other market timing

settlements to be distributed, such as \$3.2 million from Bank of America. Since we do not have detailed records regarding these settlement distributions, the money will be deposited in the corresponding fund. All distributions are within SEC and Professor Blume's guidelines.

Ms. Gallogly asked Mr. Anderson if the settlement distribution going into individual accounts will be considered taxable income. Mr. Anderson replied that it was unclear at this point, but a letter will be sent with each distribution explaining the tax guidelines.

The Treasurer entertained a motion to approve the distribution settlement for RIHEST/CollegeBoundfund as presented by the Staff. Ms. Gallogly moved, Ms. Reback, seconded and the following motion was passed. The following members voted in favor: Mr. Costello, Ms. Gallogly, Mr. Gaudreau, Dr. McKenna, Ms. Reback, Mr. Treat, and Treasurer Caprio.

VOTED: To approve the distribution settlement for the RIHEST/CollegeBoundfund as presented by Staff.

Ms. DeLong introduced Tom Fontaine, Director of Research and Investment Design from Alliance Bernstein. Mr. Fontaine remarked that the past performance of the CollegeBoundfund has been favorable. However, these are unprecedented times. There is now a flight to quality, and all asset classes have experienced negative

returns, including the

CollegeBoundfund. Mr. Fontaine reviewed the investment options within the fund. Mr. Costello observed that the returns for the fund were half of what returns were for the S&P 500. He asked Mr. Fontaine if the investment model will be changed going forward, considering the disappointing returns. Mr. Fontaine replied he would be open to a dialogue with the SIC to determine the objectives of the investment design. Mr. Fontaine stated that given their analysis and understanding of the plan, he believes the plan is prudent, and they will not be changing the asset allocation. He observed once more how extremely unusual the current market conditions are and noted there will be a rebound.

The Treasurer noted that our relationship with Alliance Bernstein is very important. He asked the Alliance Bernstein Representatives to continue the dialogue and discussion with the SIC and Staff.

Mr. Fontaine closed by remarking that the current design allows investors in the CollegeBoundfund to be well positioned once this rebound occurs. He referred to Warren Buffet's recent decision to invest in stocks, and remarked that cash is not the preferred asset allocation at this time. Treasurer Caprio stated he appreciated Mr. Fontaine's comments, and added that if these comments were in regard to our pension portfolio, this type of investment position would be prudent because the timeline is decades. However, the timeline for the CollegeBoundfund is not unlimited, but rather it is a

fixed duration. As fiduciaries, it is the SIC's responsibility to protect the investors who are participating in the fund.

Legal Counsel Report. There were no legal developments for Counsel to report for the month of September.

RFQ for Portfolio Monitoring and Securities Litigation Services. Mr. Dingley commented that the dislocation of the market will be creating an abundance of litigation. There are currently two firms who represent ERSRI in Securities Litigation, and the proposal is that the number of firms be increased by four. The Firms are Coughlin, Stoia, Geller, Rudman & Robbins, LLP, Bernstein, Litowitz, Berger & Grossman, LLP, Cohen, Milstein, Hausfeld, & Toll, PLLC, and Labaton Sucharow, LLP. The ultimate goal of these firms is to be lead plaintiff representing ERSRI, if there is cause for securities litigation.

Treasurer Caprio explained that the firms absorb all costs associated with litigation. They receive a percentage of the award, should the litigation be successful. If litigation is not successful, the firm absorbs all costs. The firms monitor our portfolio and are responsible for identifying and initiating any class action suits. The firm who brings the action to the attention of the Commission first, will most likely represent ERSRI.

The Treasurer entertained a motion to approve the Staff recommendation to expand the pool of qualified Portfolio Monitoring

and Security Litigation Firms. Mr. Treat moved, Ms. Reback, seconded and the following motion was passed. The following members voted in favor: Mr. Costello, Ms. Gallogly, Mr. Gaudreau, Dr. McKenna, Ms. Reback, Mr. Treat, and Treasurer Caprio.

VOTED: To approve the Staff recommendation to expand the pool of qualified Portfolio Monitoring and Security Litigation Firms.

Chief Investment Officer Report. Mr. Goodreau asked the SIC Members to refer to the new SIC Booklet. He explained that there would be some material changes going forward and asked for input regarding the new format. Mr. Treat commented that he was pleased with the additional information and new format.

Mr. Goodreau stated that the Russell Implementation Program is working and the portfolio had a relative 13 basis point net positive for the month. Representatives from Russell Investment Group will be attending the next SIC Meeting to explain the implementation services and to review the strategy of the plan. Mr. Goodreau noted that our portfolio exceeded the benchmark by 75 basis points during the last twelve months.

Ms. Gallogly asked if there should be any concerns regarding our Money Managers regarding the declining compensation they are receiving due to market conditions. She inquired if this will affect their staff and other resources, which could negatively impact the

portfolio. Mr. Goodreau replied this was a possibility. He added that Mr. Emkin and Mr. Burns from Pension Consulting Alliance will be monitoring this situation closely to avoid any issues that may negatively affect the portfolio.

New Business. There being no new business, the Treasurer entertained a motion to adjourn. Ms. Reback moved, Dr. McKenna seconded and the following motion was passed. The following members voted in favor: Mr. Costello, Ms. Gallogly, 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 10:54 a.m.

Respectfully submitted,

Frank T. Caprio

General Treasurer