State of Rhode Island and Providence Plantations

STATE INVESTMENT COMMISSION

Mid-Month Meeting November 5, 2008

A State Investment Commission (SIC) meeting was held in Room 135, State House, Providence, Rhode Island on Wednesday, December3, 2008. The Treasurer called the meeting to order at 9:16 a.m.

Membership Roll Call. Present were: Mr. Michael Costello, Ms. Rosemary Booth Gallogly, Mr. Robert Giudici, 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 and Mr. Joseph Rodio, of Rodio & Ursillo Ltd, Legal Counsel to the Commission; Mr. John Burns of Pension Consulting Alliance, General Policy Consultant to the Commission; Mr. Greg Nordquist, Implementation Manager, Russell Investment Group; Ms. Laura Callahan of State Street Corporation; and other members of the Treasurer's staff. Mr. Gaudreau, Dr. McKenna, Ms. Reback, and Mr. Reilly were not present.

State Investment Commission Minutes. The Treasurer entertained a motion for approval of the minutes. Mr. Treat moved, Ms. Gallogly seconded and the following motion was passed. The following members voted in favor: Mr. Michael Costello, Ms. Rosemary Booth Gallogly, Mr. Robert Giudici, Mr. John Treat, and General Treasurer

Frank T. Caprio.

VOTED: To approve the Minutes of the November 5, 2008 mid-month meeting.

Treasurer Caprio thanked all attendees for participating in this additional SIC meeting. In addition to today's presentations by PCA and Russell, he explained that he would like the staff, PCA, Russell, and Brockhouse Cooper to continue to review the current active manager's policies and costs. Treasurer Caprio stated that he would like to continue this discussion by getting the proper materials to the Commission well in advance of any meeting on current manager performance and cost structures.

The Role of Assets – Pension Consulting Alliance. Mr. Burns began by explaining how to determine the appropriate asset allocations for ERSRI's portfolio. The first step is to define objectives and the investment options which are within ERSRI's guidelines. The goal will be to exceed the benchmark of 8.25%. The next step is to create capital market rate assumptions and expected risk and return correlations for a five to ten year period. PCA will then run an analysis and the SIC will select an asset allocation that reflects ERSRI's risk and return tolerance. Mr. Burns stated that PCA utilizes a "building block" approach to arrive at estimates for equity and other classes' risk premium. The objective is to develop reasonable, consensus expectations for asset classes exhibiting different risk

characteristics. Since equity is a large percentage of the portfolio's allocation, Mr. Burns stated it is critical to estimate the equity risk premium, as this will drive returns. The estimation process will be more difficult to determine among the more esoteric classes, such as real estate and private equity. Mr. Burns noted that the SIC should be cautious and prudent in analysis of all models and
assumptions. Mr. Treat asked Mr. Burns if future economic conditions and inflation are taken into consideration when building assumption models. Mr. Burns replied that the model is indicative of many market cycles. He added that a percentage for inflation will be determined and will be built into the model.

Mr. Burns went on to discuss potential investment markets within real return asset classes. These asset classes include commodities, hedge funds, timber, infrastructure and global TIPS. Commodities that trade in the futures exchange, such as soy beans and hogs, could be used as a basis toward an absolute return strategy. Timber is similar to a bond, as it provides cash flow and has equity appreciation potential. Infrastructure, which includes ports and toll roads, provides income and ownership of the asset. Hedge funds have the potential of providing a steady, low volatility return of inflation plus 3% to 4%.

The Treasurer asked Mr. Burns how the risk related to the real return asset classes compares versus the risk associated with private equity and private equity real estate investments. Mr. Burns replied that

there is more risk associated with private equity than a combination of real return classes designed to have low volatility within a portfolio.

A discussion ensued between the SIC members and Mr. Burns regarding the volatility and risk related to different types of hedge funds. Mr. Burns and the SIC members agreed there should be a "wait and see" attitude and more discussion before an investment decision is made.

Mr. Burns remarked that a prudently structured real return portfolio should diversify equity risk while providing levels of returns greater than bonds and moderately less than equities. A significant discussion should take place to outline an appropriate real return class structure. The implementation of any one of several structures may take an extended period of time. Investments in the real return class can occur on an opportunistic basis, potentially leading to short term biases in the initial funding stages. The first step in implementation would be to develop and approve policies and guidelines that would dictate the long term structuring of the real return class portfolio. Ms. Gallogly asked if there could be some overlap in real return classes and private equity. Mr. Burns affirmed that there could be, and used TIPS as an example.

Exposure Management – Russell Investment Group. Treasure Caprio explained that the Implementation Program is a disciplined approach

to keep asset allocations within their respective benchmarks. He added that last month a deviation of +/- 1% within an asset class would trigger a rebalance. Due to the extreme volatility in the market, the staff and representatives from Russell Investments have agreed to modify the deviation to +/- 2%. The allocations have been rebalanced two times over the last two months. The Treasurer introduced Mr. Greg Nordquist, Senior Portfolio Manager, from Russell Investments.

Mr. Nordquist noted that the goal of this program is to correct unintended exposures in a passive implementation, while minimizing costs. The portfolio could be rebalanced frequently in the S&P 500 and EFA, but trading in futures space to rebalance allocations will comparatively reduce costs by approximately 90%. This method avoids the physical

transaction costs while performing a mini rebalancing from cash flow changes in an equitization program. The plan follows the market movements and then changes are traded in cash to keep allocations within the target. The Treasurer commented that having a disciplined systematic approach to rebalancing the portfolio allocations is a necessary tool. This eliminates the emotional aspect involved in the decision making process.

Ms. Gallogly asked Mr. Nordquist if the data identifying the cash used to rebalance the allocations is supplied by State Street Bank & Trust

Company. She continued by asking if the Money Managers take exception to this, as they will not have access to this cash for reinvestment. Mr. Nordquist explained that the cash is aggregated visually, but it is not removed. The policy reacts to the downloaded values that State Street provides, and the deviation in allocations is exposed to the market through futures. The methodology is to buy low and sell high. Mr. Nordquist added that there is always a cash cushion to avoid leverage.

Mr. Nordquist explained that an Asset Summary Report is sent to Mr. Goodreau and Mr. Izzo on a daily basis. This report indicates the deviations from target allocations and unintended risk versus policy. He then went on to give a detailed explanation of the last several Asset Summary Reports and explained how the Implementation Program actually keeps allocations within their respective benchmarks.

Mr. Costello asked how the efficiencies and added value of the program can be determined. Mr. Nordquist responded that Russell measures their performance versus a "perfect implementation benchmark". This benchmark is determined, in theory, by assuming what the cost would be if an investment is made in the S&P or EFA with no transaction costs associated with the trade. The performance of Russell's positions is measured relative to this benchmark. Mr. Nordquist commented that in September Russell outperformed this benchmark by approximately $2 million.

Mr. Costello stated that ERSRI does not have an allocation for cash and he questioned Mr. Nordquist as to whether this is the position ERSRI should take. Mr. Nordquist replied that very few funds within the U.S. have a strategic allocation to cash, as it is perceived as being a drag on the portfolio. Some funds may have a 2% allocation to cash, but only as a means of providing liquidity to the portfolio. Treasurer Caprio added that going forward, a study will be performed to help the SIC determine if any changes should be made to the asset allocations. This study will help the SIC decide if cash should be part of ERSRI's allocations.

Mr. Treat observed that in a previous meeting it was stated that the Implementation Program would add approximately 15 basis points to the portfolio each year. He added that a review should be done on a quarterly or semi-annual basis to determine the actual value the portfolio is capturing from this program. He remarked that during these volatile times "cash is king", and if cash is being invested in a falling market it works against the portfolio.

Mr. Goodreau noted that the portfolio had 4.5% allocated to cash, which eliminated the need to liquidate any assets to fund equities while going through the current downturn. He added that he thought the issue may be more related to the risk involved in asset classes, rather than dollars allocated to cash. He observed that cash has virtually no return in this

market and the answer may be to increase the allocation to bonds or other risk-averse asset classes. Mr. Goodreau noted that having the Implementation Program in place during this volatile time actually captured a 20% move in the market, which would not have been possible if the program was not in place. The Treasurer remarked that only a small portion of the cash allocation is used to employ the implementation strategy through investment in futures, leaving the majority of cash within the portfolio. Mr. Nordquist interjected that alternative investments involve private equity calls, real estate calls, and distributions, which require a need to have a liquidity management system in place. This program provides a long term approach to liquidity in addition to exposure to the market.

Legal Counsel Report. There were no legal developments for Counsel to report at this meeting.

Chief Investment Officer Report. Mr. Goodreau reported that Taplin, Canida & Habacht, one of ERSRI's Fixed Income Managers, is in the midst of a corporate transaction (sale of firm) and has experienced relatively poor performance in the past quarter. Under these circumstances, ERSRI's policy allows the SIC several options. These options are as follows: terminate the account and temporarily reallocate to a firm to manage as a corporate bond index fund until a structural review is completed, terminate the account and reallocate to an existing R.I. Fixed Income Manager (Pyramis or PIMCO), or

continue to retain Taplin, Canida & Habacht, until the fixed income structural review is conducted. The timeline for a fixed income structural review will be approximately six months. The Treasurer stated the SIC will be required to vote on one of these options at a future meeting.

Treasurer's Report. Treasurer Caprio updated the SIC regarding ERSRI's investment in the U.S. Government Fund. He commented that our staff attended a meeting with the SEC and a team of the major shareholders in the Fund. He explained that The Reserve Money Market has announced that ERSRI will be receiving $20-$25 million, which is approximately 30%-40% of the funds invested in the U.S. Government Fund, within the next ten days.

The Treasurer explained that all ERSRI's cash deposits are now collateralized. Due to the current volatility of the market, cash will be invested in risk-averse options.

Mr. Goodreau remarked that there are several institutions that the Federal Government is investing with that are not on our approved vendor list. The Treasurer stated that the SIC will soon be asked to approve an expanded vendor list, which will include these institutions, for possible future investments.

The Treasurer noted that the next SIC meeting will be on December3, 2008. He mentioned that there may be a need for an additional

meeting prior to this date. He asked for the Commission's cooperation regarding their additional time, and added that the members will be notified as soon as possible.

New Business. There being no further new business, the Treasurer entertained

a motion to adjourn. Mr. Giudici moved, Mr. Treat seconded and the following motion was passed. The following members voted in favor: Mr. Michael Costello, Ms. Rosemary Booth Gallogly, Mr. Robert Giudici, Mr. John Treat, and General Treasurer Frank T. Caprio.

VOTED: To adjourn the meeting.

There being no further business, the meeting was adjourned at 10:34 a.m.

Respectfully submitted,

Frank T. Caprio
General Treasurer