

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

## **STATE INVESTMENT COMMISSION**

### **Mid-Monthly Meeting December 3, 2008**

**A State Investment Commission (SIC) meeting was held in Room 135, State House, Providence, Rhode Island on Wednesday, December 3, 2008. The Treasurer called the meeting to order at 9:13 a.m.**

**Membership Roll Call. Present were: Mr. Michael Costello, Ms. Rosemary Booth Gallogly, Mr. Robert Gaudreau, Mr. Robert Giudici, Ms. Marcia Reback, Mr. Andrew Reilly, 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; Mr. Michael Bain 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. McKenna was not present and Ms. Gallogly left at 10:30 a.m.**

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

**Mr. Giudici, Ms. Reback, Mr. Reilly, Mr. Treat, and General Treasurer Caprio.**

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

**Treasurer Caprio noted that it is important for the Commission members to be aware of the various asset classes that are available for investment. He then introduced Mr. Emkin, who would be giving a background and review of Hedge Funds and Infrastructure.**

**Introduction to Hedge Funds – Pension Consulting Alliance. Mr. Emkin reminded the Commission that this is an educational exercise and he is not making an investment recommendation. Mr. Emkin explained that the term “hedge fund” can be broadly defined and it is not an asset class, but rather a type of asset management. He explained that the goal is to have asset class diversification within the portfolio that does not fluctuate with stocks and bonds. He explained hedge funds can provide superior returns relative to risk by utilizing a broad spectrum of investment styles, hedging strategies and financial instruments that have low or no market risk. Hedge funds are commonly considered alternative investments because they are privately structured and limited to sophisticated investors. Mr. Emkin also stated that hedge funds can also contain significant financial leverage and other risk factors, which can produce highly volatile returns.**

**Ms. Reback asked Mr. Emkin to explain why the presentation material indicates a risk factor for hedge funds from low risk to extremely volatile risk. Mr. Emkin explained that there are many different types of hedge funds and the risk within these various funds can range from extreme high risk to low risk strategies. If hedge funds were part of ERSRI's portfolio, funds would be chosen that would have a moderate risk factor. Mr. Emkin closed his presentation by commenting that this is not the appropriate time for ERSRI to consider investment in hedge funds.**

**Mr. Giudici asked how hedge funds have performed during the last five years. Mr. Emkin replied that it would vary depending on the fund. Five years ago, the hedge fund market share was rather small. The performance was good for three to four years, followed by a year of drastic under performance. The result of the five year time horizon indicates most hedge funds broke even. The discussion then went on to Infrastructure.**

**Introduction to Infrastructure – Pension Consulting Alliance. Mr. Emkin provided an educational overview of Infrastructure as a potential asset class within the portfolio. Investments in Infrastructure pertain to physical structures, facilities, and networks which provide essential services within a community. There are three predominate types of Economic Infrastructures: transportation, energy utilities, and communications. Social Infrastructure includes**

educational facilities, healthcare facilities, correctional facilities, and judicial buildings. Infrastructure investing has been an asset class for many years, but was previously referred to as Project Finance. Recently, public to private partnerships have been formed to help public entities with their balance sheet while providing investment opportunities in the private sector. It is a method of providing capital for growth and maintenance of institutions without using taxpayer money. Many pension plan investors are embracing Infrastructure investments, including CalPERS and CalSTRS.

Ms. Reback asked for an example of an Infrastructure investment. Mr. Emkin replied that Heathrow Airport in London is not operated by the government, but rather it is operated by a private company. There was a discussion regarding the complexity of labor issues within an Infrastructure investment. Mr. Emkin went on to explain how many of the companies they provide with consulting services have handled labor issues in the past.

Mr. Emkin stated that Infrastructure as an asset class offers stability, long life assets, inflation protection, predictable cash flow, limited risk and volatility. Infrastructure is not reflective of the highs and lows of stocks and bonds and is well regulated. Infrastructure is a hybrid asset class with similarities to traditional asset classes, such as fixed income, private equity, and real estate. These investments can be either in North America or global.

**Mr. Costello asked why a state would privatize Infrastructure if the state could conceivably find a way to raise the capital to fund the Infrastructure and capture the returns themselves. Mr. Emkin replied that it is sometimes a matter of limited tax exempt financing for Infrastructure on the part of the state, or operating efficiencies may be superior to that of the state if done by a private company.**

**Potential investor concerns can be leverage, market inefficiencies, political and headline risk, regulatory risk, construction and development, labor issues and asset management control.**

**Today's political spotlight has been placed on America's Infrastructure as a catalyst to create jobs and spur the economy. Government is facing budgetary constraints and looking for ways to address Infrastructure spending shortfalls. Also, the slowdown of alternative markets due to the credit crunch and financial crisis will increase the need for private capital in Infrastructure.**

**PCA expressed their belief that there are many great investment opportunities in Infrastructure. However, at this point they are providing general background information. Mr. Emkin suggested that when reviewing asset allocations, the Commission consider Infrastructure as an investment. At that time, PCA will bring more complex information and vendors to see what is being offered in the marketplace.**

**The Treasurer asked Mr. Emkin to comment on the current market**

conditions. Mr. Emkin stated that the cause of the volatility in the stock market is due to the credit markets. Businesses, both large and small, are not able to borrow money. Banks are not lending money and the public is not buying corporate bonds. Until there is a more readily available source of borrowing, the volatility will continue. Mr. Emkin commented that the new Administration has put together a very talented team in both the Treasury and Regulatory Departments, which is encouraging. He remarked that there are tremendous investment opportunities in the market because of current conditions.

Treasurer Caprio stated that over a year ago ERSRI decided to continue a Securities Lending Program, but invested the collateral in very low risk options, such as treasury holdings. This has proven to be a positive decision in regard to the portfolio. He asked Mr. Emkin to comment further on the Securities Lending Program. Mr. Emkin explained that many investors lost large sums of money by investing collateral in risky assets that had historically been great performers with little to no risk associated with the investment. This changed about nine months ago when investments such as commercial paper and short term bonds had huge losses. The Treasurer asked Mr. Goodreau to continue the discussion in regard to performance of ERSRI's Security Lending Program.

Mr. Goodreau remarked that last year, at the Treasurer's request, ERSRI moved the Securities Lending Program collateral from Quality

**D Fund to Quality A Fund. The Program has been under constant scrutiny and review by the staff. Earlier in the week a meeting was held with the staff, Mr. Burns from PCA, and Mr. DeSano from State Street Bank & Trust, to review the portfolio once again to be sure the collateral pool was in risk averse investments with no third party risk.**

**To date, ERSRI's Securities Lending Program has earned \$8 million in returns. Mr. Goodreau cautioned that if and when the demand for treasuries diminishes, the returns will not be as lucrative. Mr. Costello asked why the returns are so high when treasury yields are very low. Mr. Goodreau replied that the returns are coming from the premium being paid on our holdings, not the risk of the collateral pool.**

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

**Chief Investment Officer Report. Mr. Goodreau remarked that leverage is not working and the cost of capital is going up. The priority now should be to determine which asset classes can provide good returns with minimal risk. There are opportunities in capital markets, credit markets and dividend paying strategies. On a relative basis the portfolio is exceeding the benchmark by 150 basis points. In the next mid-monthly meeting there will be a review of active manager's fees.**

**Mr. Reilly and Mr. Goodreau had a quick discussion regarding the**

portfolio's remaining \$10 million investment in Lehman Brothers Merchant Bank Fund IV. Mr. Reilly noted that Lazard has been acting in an advisory role for Lehman Brothers since last July. Lazard is currently trying to find a buyer for the Lehman Brothers' owned portion of the General Partnership. Mr. Goodreau remarked that the underlying assets are viable and there is a very high probability that the fund will be purchased.

**Alternative Investments Consultant- Market Review.** Although PCG was not on the agenda, Treasurer Caprio asked Mr. Bain to comment on market conditions within private equity. Mr. Bain stated that lack of liquidity has caused softness in the alternative investment market, which is expected to continue for quite some time. For the long term, the portfolio is in good standing. Managers of these investments have been chosen because they create value through active management operational improvements, rather than financial engineering and use of leverage. The portfolio should rebound and weather the down turn. Liquid strategies and credit based strategies, such as mezzanine investments, have become a major area of opportunity. ERSRI's investment timing in the secondary market has been successful and the secondary market will continue to be an attractive investment. Distressed debt strategies will continue to be favorable in the current market conditions. ERSRI will have the opportunity to capitalize in their current investments in distressed debt. Mr. Bain concluded by remarking that valuations are coming down and top managers are coming back to the market in 2009, which

**will create many opportunities in a strong vintage year.**

**Treasurer's Report. Treasurer Caprio announced that our Cash Management team has received a commitment from the SEC and the U.S. Treasury Department regarding ERSRI's remaining investment in The Reserve U.S. Government Fund. The Treasurer and several of the largest shareholders of the Fund, met in Washington with the SEC. Several top ranking members of the U.S. Treasury also assisted in the resolution. According to the U.S. Treasury, The Reserve U.S. Government Fund will use its best efforts to sell all portfolio securities by January 3, 2009. The Treasury, through the Exchange Stabilization Fund (ESF), has agreed to purchase any securities remaining in the Fund on January 3, 2009. This agreement will allow the Government Fund to return all of the Fund's money by early next year. This will eliminate our liquidity issue with short term cash management.**

**The Treasurer then went on to address the concerns that ERSRI's members have expressed due to the recent volatile market conditions. Treasurer Caprio asked the Fund's actuaries to project what the value of the portfolio would be in 2038. The projection was based on the following assumptions: the portfolio would have approximately \$6 billion in funds, the portfolio would average a 0% return, the members would continue to contribute the same percentage of earnings, and employers would continue to contribute the same range of funds. The results indicated that at the end of the**

thirty eight years the portfolio still would have approximately \$2.5 billion. Treasurer Caprio went through this exercise to assure ERSRI's members that the portfolio is capable of withstanding a downturn if market conditions continue to deteriorate for an extended period of time.

Ms. Reback asked what effect the inordinate number of recent retirees will have on the portfolio. Treasurer Caprio replied that a report will be available at the next Retirement Board meeting on Wednesday, December 10th.

The Treasurer remarked that when the market begins to recover, the asset allocations that the Commission has chosen within the portfolio will be positioned to capture these returns. Many other Funds will be scrambling to re-allocate assets similar to our allocation strategy. Predictions are now being made by financial analysts that over the next one to two years there will be a 50% return in the S&P and "FTSE". If these predictions are realized, ERSRI's portfolio will gain significant returns. The Treasurer asked the Commission to refer to the 2009 Meeting Schedule, remarking that the mid-monthly meetings will continue until further notice. Treasurer Caprio commented that the Commission, along with PCA Consultants and Brockhouse Cooper, will be reviewing manager fees at the December 17, 2008 meeting. Mr. Costello requested the Commission also review new opportunistic asset classes. The Treasurer agreed.

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

**VOTED:** To adjourn the meeting.

There being no further business, the meeting was adjourned at 10:50 a.m.

Respectfully submitted,

**Frank T. Caprio**  
**General Treasurer**