State of Rhode Island and Providence Plantations

STATE INVESTMENT COMMISSION

Mid-Month Meeting January 13, 2009

A State Investment Commission (SIC) meeting was held in Room 135, State House, Providence, Rhode Island on Tuesday, January 13, 2009. The Treasurer called the meeting to order at 9:04 a.m.

Membership Roll Call. Present were: Mr. Michael Costello, Mr. Robert Gaudreau, Dr. Robert McKenna, Ms. Marcia Reback, Mr. Andrew Reilly, Mr. John Treat, Mr. Robert Giudici, and General Treasurer Frank T. Caprio. Also present were: Mr. Kenneth E. Goodreau, Chief Investment Officer; Ms. Sarah Dowling, of Adler Pollock & Sheehan; Mr. David Ursillo, of Rodio & Ursillo, 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 Investment Consultant to the Commission; Ms. Laura Callahan and Mr. Craig DeGiacomo, of State Street Corporation; and other members of the Treasurer's staff. Ms. Rosemary Booth Gallogly arrived at 9:15AM.

State Investment Commission Minutes. The Treasurer entertained a motion for approval of the minutes for the meeting of December 17, 2008. Ms. Reback moved, Dr. McKenna seconded, and the

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

VOTED: To approve the Minutes of the December 17, 2008 Monthly meeting.

Treasurer Caprio introduced Investment Cash Manager, Mr. Vincent Izzo, who gave an update on short term investment guidelines.

Short Term Investment Cash Management Update. Mr. Izzo advised the group that we are now able to meet our policy guidelines thanks to the Commission's two recent approvals regarding Collateralized Deposits and CD instruments and the addition of three new vendors. CDARS transactions through Sovereign Bank will be starting shortly and we are looking for an additional yield of 100 bps. A brief discussion ensued regarding CDARS and its maximum contribution amount and term requirements; it was clarified that the maximum contribution amount is $50 million and the term required is a minimum of 4 weeks and a maximum of 3 years.

Treasurer Caprio then introduced Mr. Allan Emkin and Mr. John Burns of PCA. The Treasurer noted that an information packet on Efficient Market Equities had been distributed to board members in anticipation of this presentation.

Asset Allocation – Passive Implementation Recommendations. Mr. Emkin and Mr. Burns presented the board with a recommendation to move from our current asset allocation strategy of active management to a more passive approach that concentrates heavily Equity Markets. It was explained that our current strategy is based on the philosophy that the active managers, which were selected by the SIC, are skilled in stock selection and as such, their skill can add value.

PCA's proposed approach is based on the following philosophy: (1) the principle that Equity Markets are relatively efficient; (2) active management is a negative sum game after commissions and fees; (3) stock selection is difficult over long periods of time; (4) while some managers will exhibit stock selection skills after the fact, it is difficult to select those managers that will deliver future stock selection skills; (5) indexing will provide market return at minimal costs; (6) future allocation to active managers will be made to gain new exposure to non-correlated assets.

Mr. Burns reviewed our current US Equity and Non-US Equity Portfolio structures and juxtaposed both against the proposed 80-100% indexing configuration. Currently, the US Equity structure is 58% actively managed with four managers and fees of 24.5 bps, while the Non-US Equity structure is 100% actively managed with three managers and fees of 43.5 bps. However, the move to indexing 100% of the portfolio would allow us to reach the benchmark return without

the negative effect when factoring in fees. A rough estimate of fees for indexing both the US Equity and Non-US Equity funds would be approximately 1.2 bps for US Equity funds and 3.5 bps for Non-US Equity funds. As a result of indexing these funds, an annual cost savings of approximately $11.725 million would be realized.

Treasurer Caprio observed that, currently, the US Equity Chart indicates an average active management fee of 24.5 bps; the Treasurer further noted that a strong correlation exists between said the fee and the underperformance of the fund. The amount by which the fund has underperformed the benchmark is approximately the amount of active management fees paid by the fund.

Mr. Emkin added that consultants have been advising active managers against idiosyncratic risk in investment portfolios, therefore making the portfolios look more like the underlying benchmarks; these benchmarks, when aggregated, reflect those of both the Russell 3000 and Dow Wilshire 5000. Hence, by controlling risks, we have essentially created an index fund with active management fees.

There was a discussion regarding the returns generated by active management. It was noted that, when compared to the index, the fund earnings were negative and we had paid for the generation of alpha without an incremental return. However, if we had invested solely in indexes, we would have added value. It was suggested that

the commission should not disregard the individual active managers who had over preformed. Mr. Emkin advised the board that individual performance data is available, but cautioned that past performance does not necessarily indicate future success.

Mr. Emkin presented further information regarding other Pension Funds who have moved from an active to passive management approach. He explained that passive management has been used for many years and that, generally, the larger the fund, the greater the allocation being indexed

Mr. Emkin then moved on to discuss passive management risk. The Index portfolio would be a configuration of securities, with market risk being the only business risk. These portfolios would be relatively easy to manage, as decisions would be made through the use of technology and would be implemented by traders, so as to minimize cost.

Ms. Gallogly asked Mr. Emkin to address both the timing and the liquidation process for moving to an Index Fund. Mr. Emkin explained that in liquidating the portfolio, we would be moving to a more diverse stock portfolio from a more concentrated one, although the value would be comparatively similar; the amount to be "crossed," or transferred, would be suggested by the selected investment manager. The manager would work to minimize the cost of the restructuring process, which would include moving securities

in existing portfolios, through such endeavors as discussing options with investment managers and securing trades at low fees.

When asked about the possibility of keeping current active managers, Mr. Emkin advised the board that these managers reflect the current market and do not add the diversification that would be needed within the potential 20% active allocation. He suggested that we instead seek management strategies that are not sensitive to the same economic factors as the broad equity markets, nor resemble the broad US Equities and/or International Equities indices.

Mr. Goodreau added that this shift would not be solely about cost savings and creating efficiencies, but gives the board an opportunity to focus on the value that can be added to the 20% allocation. Essentially, we would try to create efficiencies where possible, while focusing on the 20% active allocation. Mr. Goodreau noted that our active managers should not only concentrate on performance, but should also create more entrepreneurial and innovative strategies that are consistent with a total return focus.

Mr. Costello asked if an index fund strategy would represent real equity purchases, to which Mr. Emkin replied, yes, we would be holding all of the actual equity securities.

Mr. Reilly asked what the selection process for passive mangers would be, considering the variances in performance. Mr. Emkin

explained that although the performance variances are within 1-3 bps, a Request for Proposals (RFP) would be issued to ensure competitive bidding and transparency.

Mr. Treat asked why there was a change in the proposed benchmark from the Wilshire 5000 to the Russell 3000. This change was suggested, it was clarified, to guarantee the ease of implementation. Whereas the Wilshire 5000 has more stocks, some of which are very small, the Russell 3000 covers 98% by market cap weight of the Wilshire 5000, resulting in the same correlation. Additionally, it was noted that the Russell 3000 provides broad exposure, which includes large, mid, small, value, and growth providing the desired diversification.

Treasurer Caprio then moved on to the proposed resolution, which would change the means of achieving our equity asset allocation by allotting 80-100% of our allocation through a passive strategy and 0-20% through an active strategy. If adopted, the present policy would change immediately and the search for passive managers through the RFP process would commence. The new strategy would also allow us to employ an active manager with an initially small investment and then quickly respond to their performance.

The Treasurer entertained a motion, made by Dr McKenna, to adopt the resolution as presented in the provided materials. Ms. Reback and Mr. Giudici seconded; there being no further questions, the

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

VOTED: To adopt the Resolution as presented in the information package to the Board.

Treasurer Caprio then introduced Mr. Craig DeGiacomo, Relationship Advisor with State Street, and the current provider of our S&P Index funds. Mr. DeGiacomo was present to answer any questions regarding indexing and the differences that may appear between such and the benchmark.

Mr. DeGiacomo began by expressing his agreement with Mr. Emkin and Mr. Burns regarding the current marketplace and the trend toward indexing. He noted that the need for cost efficiency, ease of implementation and increase in liquidity are major factors for public funds moving from active to passive management.

Mr. DeGiacomo explained that State Street has a variety of Index Funds available, including lending and non-lending, commingled or separate accounts.

He continued with a brief explanation of the risks of index funds, custodial risk, and the impact of concentrating all our investments with one fund. He noted that more in-depth information on these

issues would be presented in State Street's RFP.

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

Chief Investment Officer Report. Mr. Goodreau had nothing further to discuss.

New Business. There was no new business.

The Treasurer entertained a motion to adjourn. Ms. Reback moved, Dr. McKenna seconded and the subsequent motion was passed. The following members voted in favor: Ms. Reback, Dr. McKenna, Ms. Gallogly, Mr. Costello, Mr. Gaudreau, Mr. Giudici, Mr. Reilly, Mr. Treat, and General Treasurer Caprio.

VOTED: To adjourn the meeting.

There being no further business, the meeting was adjourned at 11:10 a.m.

Respectfully submitted,

Frank T. Caprio

General Treasurer

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