State of Rhode Island and Providence Plantations

STATE INVESTMENT COMMISSION

Mid-Month Meeting January 28, 2009

A State Investment Commission (SIC) meeting was held in Room 135, State House, Providence, Rhode Island on Tuesday, January 28, 2009. The Treasurer called the meeting to order at 9:20 a.m.

Membership Roll Call. Present were: Mr. Michael Costello, Ms. Marcia Reback, Mr. John Treat, Mr. Robert Giudici, Ms. Rosemary Booth Gallogly, 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. John Burns of Pension Consulting Alliance, General Policy Consultants to the Commission; Lisa H. Tyrrell, of State Street Corporation; and other members of the Treasurer's staff. Mr. Andrew Reilly, Mr. Robert Gaudreau, and Dr. Robert McKenna were not present.

State Investment Commission Minutes. The Treasurer entertained a motion for approval of the minutes for the meeting of January 13, 2009. Ms. Reback moved, Mr. Costello seconded, and the subsequent motion was passed. The following members voted in favor: Mr. Costello, Ms. Reback, Ms. Gallogly, Mr. Giudici, Mr. Treat, and General Treasurer Caprio.

VOTED: To approve the Minutes of the January 13, 2009 Mid-month meeting.

Treasurer Caprio addressed an omission on the Agenda of January 13, 2009. The vote taken on the Passive Implementation Recommendation and Resolution did not contain an asterisk on the posted Agenda indicating this item would be voted upon. For open meeting purposes the Treasurer asked that there be a vote on the discussion and the Resolution presented at the last meeting. The Treasurer asked if there was any further discussion on the movement from Active Management to Passive Management. Mr. Costello asked to have the discussion notes on the issue of Passive Implementation and Resolution from the minutes of January 13, 2009, be included in today's minutes.

Discussion notes from SIC Meeting Minutes of January 13, 2009:

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 in 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

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 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.

There being no further comments, the Treasurer entertained a motion, made by Mr. Treat, seconded by Ms. Reback and Mr. Costello. To adopt the Resolution as presented in the previously provided materials. The following members voted in favor: Mr. Costello, Ms. Gallogly, Mr. Treat, Ms. Reback, Mr. Giudici, and General Treasurer Caprio.

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

Treasurer Caprio then turned the meeting over to Mr. John Burns, of PCA, for the General Consultant review.

Mr. Burns began by addressing Indexing and the differences between the major broad market indices for US Equities. He compared characteristics of the S&P 500, Russell 3000, and Dow Jones Wilshire 5000. In choosing an index, it is best to get a broad representation of all types of stocks, large cap, small cap, growth, and value in an efficient manor. The key factor to focus on should be the weighted average market cap. All of these funds are weighted on large cap stocks with the S&P 500 having the heaviest weighting. The charts indicate that there are not any material differences between indices relative to each other. A review of the charted Economic Sector again showed the relative closeness of these indices.

At this time, Mr. Burns stated PCA's recommendation the Russell 3000 Index Fund because it offers the best combination of broad diversification and ease of implementation.

He continued by addressing the size of these funds. Anything larger than $10 billion is considered large cap, $2-10 billion being mid cap and anything below $2 billion would be considered small cap. The Russell 3000 provides a balanced mix. Also, the S&P 500 is not market cap based, but stocks are chosen by a group of "experts" to reflect the US Equity economy. The Russell 3000 and the DJ Wilshire 5000 stocks directly reflect their place and size in the market. Lastly, performance and correlation are all very close amongst the funds.

The Russell 3000 can be broken down by choosing a combination of the largest 1000 stocks, the Russell 1000 and the smallest 2000 stocks, the Russell 2000. This mix will provide us with the flexibility as to how to get to the Russell 3000. Also of note, currently the Russell 3000 is widely used by institutional investors.

The Treasurer asked what would be the correlation between S&P 500 and Russell 3000. These funds would be very close since 95% of the Russell 1000 is part of the S&P 500. The remaining stocks not part of the S&P have a small market cap rating with little effect.

Currently the Wilshire 5000 is our policy benchmark but we do not index to it. All our present managers have specific mandates typically to the S&P 500, or if they are small cap the Russell 2000. In making a passive shift, we will not go to broad Russell 3000 but we will actually breakdown each component into either the Russell 1000 or Russell 2000. As we gravitate toward passive management the Policy benchmark would be the Russell 3000.

Legal Counsel Report: Legal Counsel did not have any report. Treasurer Caprio asked Legal Council to discuss with Mr. Izzo the pending short term cash changes to insure proper legal review.

Chief Investment Officer Report: Mr. Goodreau gave an update on the Request for Proposals (RFP). The RFP was issued on Friday, January 23. Institutions will have ten days to respond. We will be screening for institutional credibility, structural integrity, cost and future options. As soon as we have these responses, our search consultant, Brockhouse Cooper and PCA will screen the data and will then come back to the Commission with recommendations.

There was a discussion regarding the recent changes at State Street. Mr. Goodreau indicated there have been several discussions with State Street regarding the recent events. Most of our concerns were addressed in the past when we were discussing the move from Quality D to Quality A portfolio. Currently, we are satisfied that we are substantially insulated from any risk. In the past year and one half, we have worked with State Street to ensure that we have no unintended risk to these types of asset classes and all data suggests we do not.

He continued by addressing the securities lending program and what had been done to insulate ourselves. In the spring of 2007, in conjunction with a review of all cash holdings in the security lending pool we had $1 billion with State Street. Quality D was a fund of approximately $100 billion with covenants that allowed them to buy both rated and unrated investments. Quality A was a fund of $10 billion with tighter covenants whose investments had to be rated and mostly government backed securities. After reviewing these funds, we voted to move from Quality D to Quality A portfolio in order to provide the safest investment vehicle. We have continued to do comprehensive reviews of this portfolio with State Street and are continuing to do monthly reviews and quarterly reviews on a face to face basis.

Treasurer Caprio suggested that any information provided to us by State Street regarding different funds and their decline in stock prices be shared with the Commission.

Mr. Treat asked if the spread between the Quality A and Quality D Portfolio has widened as a result of these issues. Ms. Tyrrell explained that typically Quality D has a higher yield than Quality A however she was not aware of the exact spread differences and suggested she get that information for the commission.

Ms. Gallogly asked what the risk would be of the capacity of the fund if all investors wanted their securities back at the same time. Mr. Goodreau explained that recently he had asked State Street to provide us with a "stress test" of unforeseen and unprecedented events that would impact our fund. The results of the test will be provided once they are received.

Mr. Burns added that the SIC has done all it can to insure that securities lending is as safe as possible. However, the yield on the fund is being paid because there are risks. There are certain scenarios which can pose a risk such as interest rates rising suddenly, or unexpected credit events that may cause a decrease in yield or possibly result in a loss of principal.

At this time, Lisa Tyrrell of State Street spoke regarding securities lending programs. She noted that none of State Street's clients have had any losses regardless of Quality A or Quality D. As for exiting, State Street follows ERISA guidelines, which means they treat all participants fairly, so that if one participant has a larger participation in the Pool they would not receive more money, everyone comes out exactly the same. If there were to be a run of customers trying to get out quickly, State Street would work with it customers who may have to take a pro-rata of actual shares and not get all cash. Customers may get cash based upon your percentage of participation in the program. State Street believes this is the fairest way to treat all investors.

Based upon this discussion, the Treasurer asked Mr. Goodreau to find out what the exit strategy would be if we chose to exit quickly and report back to the Board.

Treasurers Report. Treasurer Caprio reported that we have received the final payment from The Reserve Fund. Mr. Bent, president of the fund family, thanked and complimented us for getting officials in Washington involved and today the US Treasury is using the same model which was setup for the Reserve Fund to now use the TARP funds to purchase other government guaranteed debt.

New Business. There was no new business.

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

VOTED: To adjourn the meeting.

There being no further business, the meeting was adjourned at 11:20 a.m.

Respectfully submitted,

Frank T. Caprio
General Treasurer