State of Rhode Island and Providence Plantations

STATE INVESTMENT COMMISSION

Monthly Meeting April 22, 2009

A State Investment Commission (SIC) meeting was held in Room 135, State House, Providence, Rhode Island on Wednesday, April 22, 2009. The Treasurer called the meeting to order at 9:08 a.m.

Membership Roll Call. Present were: Mr. Michael Costello, Ms. Rosemary Booth Gallogly, Mr. Andrew Reilly, Mr. John Treat, Mr. Robert Giudici, Mr. Robert Gaudreau and General Treasurer Frank T. Caprio. Also present were: Mr. Kenneth E. Goodreau, Chief Investment Officer; Ms. Sarah Dowling, of Adler, Pollock, and Sheehan; Mr. David Ursillo, of Rodio & Ursillo, Legal Counsel to the Commission; Mr. Allan Emkin and Mr. John Burns of Pension Consulting Alliance (PCA), General Policy Consultants to the Commission; Ms. Laura Callahan of State Street Corporation; and other members of the Treasurer's staff. Ms. Marcia Reback and Dr. Robert McKenna were not present.

State Investment Commission Minutes. Treasurer Caprio entertained a motion for approval of the minutes for the meeting of April 7, 2009. Mr. Treat moved, Mr. Giudici seconded, and the subsequent motion passed. The following members voted in favor: Mr. Costello, Ms. Gallogly, Mr. Giudici, Mr. Reilly, Mr. Gaudreau, Mr. Treat, and General

Treasurer Caprio.

VOTED: To approve the Minutes of the April 7, 2009 monthly meeting.

General Consultant Report. Mr. Burns began with the presentation of the Allocation Study – Optimizations, which affirm PCA's goal of providing the Commission with suggested asset allocations which are able to achieve the highest target returns with the lowest risk.

There was a brief discussion of how our fund compares with other public funds. It was noted that real estate allocations were higher in other public funds. Mr. Emkin explained that historically real estate investments were a source of cash flow and not capital appreciation. Today real estate investments are in value added funds with higher risk, leveraged transactions, which look like private equity.

Mr. Burns discussed Risk Measures including investment return volatility, measured by standard deviations, and the probability of not achieving a target rate of return. Volatility of funding ratios, surpluses and employer contributions are excluded from this study and are part of risk allocation studies.

Ms. Gallogly questioned if there were any exceptionally volatile periods where standard deviations were not included in historic data. Mr. Emkin explained that this would understate the level of volatility

and the period we are currently experiencing will be included in the data increasing the volatility level of all assets.

Mr. Burns continued defining the downside of deviation, which he characterized as a failure to meet a minimum return target (8.25%). In showing normal distribution of return, the focus would be on expected return (8.5%) and the target return (8.25%). Risk is being redefined as not meeting the 8.25% target return as opposed to not meeting the return output of the model. This changes the model and indicates True Risk.

Mr. Burns reviewed the model's constraints along with proposed changes. Private Equity was proposed at 5-10% and the new proposal would be 7.5-10%. TIPS would be allocated into the Real Return class with a proposed allocation of 7.5%-15%. This would change the Fixed Income allocation from 25-40% to 20-40%. Based upon the newness of the Opportunistic class, the allocation would be changed to 0-5% from 0-10%. Lastly, based on our liquidity requirements, PCA suggested setting a 2% cash allocation.

Based upon the proposed constraints, PCA created an initial model for the Commission. The model generated forty different proposals with minimal deviations. In reviewing these proposals, Non US Equity Portfolios and US Equity Portfolios were reduced and new allocations set in Real Return and Opportunistic Portfolios.

Mr. Dingley questioned if the Non-US Equity Portfolio included exposure to emerging markets. Mr. Emkin acknowledged there is minor exposure and that today's market weight would be ± 10%.

In conclusion, the proposed portfolio offers a better risk/return tradeoff than our existing portfolio. The addition of diversified assets will improve return and risk profiles, and based upon input assumptions, the resulting choices would revolve around Real Return, Private Equity, and Opportunistic portfolios weighting. Future discussions will include the addition of ranges around asset allocations, rebalancing policy, and setting a risk management protocol.

Mr. Burns presented an initial outline of an Opportunistic Portfolio Investment Policy. He noted that the Commission would need to construct an investment policy and management structure that will define the components of the portfolio and its objectives. The Policy suggested that the Opportunistic Portfolio investments would focus on strategies instead of asset classes. The primary objective is to locate investments with cyclically high absolute returns. These investments are rare. However, due to market dislocations, they have become more available. The secondary objective would be to focus on unique investments, which fall outside of current asset classes, have sharp ratios of return versus risk, low correlation with the total portfolio and strategies requiring highly specialized skill sets. Mr. Burns stressed that success in this Portfolio would be to invest only

when there is real opportunity and not to fill the asset allocation.

The benefits of an Opportunistic allocation would be to allow the plan maximum flexibility of investments to meet its objectives. Suggested exclusions would be Hedge funds, commodities trading strategies, intensively derivative based investments or investments with complex strategies that are difficult to manage, explain, or understand.

The Treasurer asked for an example of an investment choice that might fit into the Opportunistic Portfolio. Mr. Emkin suggested Bank Loans, which are loans made to senior quality corporations and have traditionally traded close to par. Due to today's credit issues, these performing loans are trading at 60 to 75 cents on the dollar. The Bank Loans offer a unique opportunity as they have been affected by the current prices, are widely marketed and are an understandable known entity.

Continuing, Mr. Burns noted that the Opportunistic Policy would not require diversification guidelines within the portfolio allocation since the diversification would be at the total fund level.

The Policy should reflect the type of risk the Commission is willing to undertake along with Risk Management including investment guidelines, due diligence processes, reporting requirements, and Commission oversight.

There was a discussion regarding the Opportunistic investment process given the current restrictions on the Portfolio. The Treasurer explained that we currently have two methods we follow when making investment decisions. One is part of the investment guidelines and purchasing process and the other is within statute. To date, we have followed past practices where our consultant would make a recommendation on private equity and real estate limited partnerships allowing us to entertain the recommendation without an RFP. The policy will need to address how we can have flexibility in these new asset classes considering our purchasing laws and current processes for private equity.

Mr. Burns explained that the success of the portfolio is dependent on the timing of the investment including entering and exiting strategies. PCA recommends the Commission set an exit strategy of expected return when entering into the investment. The policy should state loss aversion is more important than opportunity costs. Additionally, the portfolio does not require being fully invested in this class, any reduction in exposure automatically puts the money into the remaining asset classes and remains fully invested.

In setting minimum and maximum initial investment guidelines, the Opportunistic policy separates unique exposure (investments that do not appear anywhere else in the portfolio) and existing exposure (investment appears within a different asset class). The suggested

investment would be greater for a unique opportunity as opposed to an existing one.

Benchmarks need to be set as policy for measurement of value added. The portfolios actuarial target is 8.25 % and additional shorter-term investments would require benchmark measurements.

The investment management philosophy states that the investment must be undervalued with significant compelling opportunity. These investments may be the result of a market dislocation or a paradigm shift where changes in regulation may create opportunity. Momentum strategies should not be included in the portfolio and this exclusion should be stated in the policy.

There was discussion regarding a fund our size adopting this class due to the complicated execution. Mr. Emkin reaffirmed the money is invested only if the opportunity presents itself; otherwise it stays fully invested in the strategic asset allocation. PCA's experience has been with very significant public institutions that have very large sophisticated staffs. Rhode Island's fund would be more consultant driven. In conclusion, from a practical point of view without sufficient staff, implementation of consultant recommendations will be extremely difficult and could result in missed opportunities.

Mr. Goodreau responded that with recent advances in gaining exposure to different asset classes, some of these opportunities

could be vetted through resources like PCA, Russell, Ned Davis Research, or State Street analytics group.

Mr. Treat related two points. First, having parameters set in advance on the sell side would provide management the flexibility needed to handle time sensitive investments. In addition, some of the opportunistic private equity alternatives we currently hold may be involved in these opportunistic investments and it would be prudent for us to review these before we widen our exposure.

Mr. Giudici expressed concerns with attempting to evaluate the degree of risk rather than achieving a particular rate of return, as well as the effective and consistent timing of entering and exiting investments. Mr. Emkin concurred adding that it is extremely important to have metrics in place so the process is thoughtful and quantitative rather than arbitrary.

Ms. Gallogly questioned who would be responsible for the exit strategy since previously we have had vendor presentations defining benchmarks before deciding to invest. Treasurer Caprio advised not overweighting the reality of the process. He further explained that if an active manager were executing the strategy, our board could call a meeting within 14 days. If a consultant recommended a suitable investment, the vendor would present it and recommend an exit strategy. If the investment were more of an index style, we would rely on whomever we were purchasing the investment from or the consultant to provide a breakdown.

Legal Counsel Report. Legal Counsel had no report.

Chief Investment Officer Report. Mr. Goodreau updated the Commission on the status of the funds transitioning from active to passive management. The transition of the domestic and international equities to index investments is largely complete and has been done at low cost. Upon completion, we will have transferred approximately $1.7 billion into different mandates. We would normally pay 40-60 bps management fee and these fees will probably be reduced to 1-4 bps resulting in a savings of 80-90%. The real costs of active trading are the market impact, which we evaluate on a quarterly basis. This comes at a cost of anywhere from $3-5 million not including fees. These are all hidden costs, which, along with decreased management fees should result in considerable savings.

Treasurer's Report. Treasurer Caprio had no report.

New Business. Ms. Gallogly requested proxy voting information be discussed at the next meeting.

There being no further new business, the Treasurer entertained a motion to adjourn. Mr. Giudici moved, Ms. Gallogly and Mr. Costello seconded and the subsequent motion passed. The following

members voted in favor. Mr. Costello, Mr. Reilly, Ms. Gallogly, Mr. Giudici, Mr. Gaudreau, Mr. Treat, and General Treasurer Caprio.

VOTED: To adjourn the meeting.

There being no further business, the meeting was adjourned at 10:48AM.

Respectfully submitted,

Frank T. Caprio
General Treasurer