State of Rhode Island and Providence Plantations

STATE INVESTMENT COMMISSION

Monthly Meeting May 27, 2009

A State Investment Commission (SIC) meeting was held in Room 135, State House, Providence, Rhode Island on Wednesday, May 27, 2009. The Treasurer called the meeting to order at 9:28 a.m.

Membership Roll Call. Present were: Mr. Michael Costello, Ms. Rosemary Booth Gallogly, 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; Mr. Paul Campellone, of Adler, Pollock, and Sheehan; Mr. David Ursillo, of Rodio & Ursillo, Legal Counsel to the Commission; Mr. John Burns of Pension Consulting Alliance (PCA), General Policy Consultants to the Commission; Ms. Lisa Tyrrell of State Street Corporation; and other members of the Treasurer's staff. Ms. Marcia Reback, Mr. Robert Gaudreau 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 22, 2009. Mr. Reilly moved, Ms. Booth Gallogly seconded, and the subsequent motion passed. The following members voted in favor: Mr. Costello, Ms. Gallogly, Mr. Giudici, Mr. Reilly, Mr. Treat, and General Treasurer Caprio.

VOTED: To approve the Minutes of the April 22, 2009 monthly meeting.

General Consultant Report. Mr. Burns ensued with a presentation of asset allocation centered on the material provided in Asset Allocation Study – Optimizations II.

He addressed the issue raised in the last meeting of adding non-U.S. equity to the model. In years past you could reduce volatility of your total fund by adding international equity, however, over the last decade the correlation between U. S. markets and non-U.S. markets has increased so the benefit from a diversification point of view has diminished. This high correlation is likely to occur in the future.

Mr. Burns reviewed the model's constraints. The imposed constraints reflect the commission's preferences and the possible outcomes. For example, under no possible circumstance could this model come out with a 70% U. S. equity. It is capped at 50% and has to have a minimum of 30%. The changes from our initial model are the separation of TIPS and the inclusion of a 2% fixed liquidity, the other classes are tweaked to reflect the commissions preferences. Non-U.S. equity and real estate are the same as the original model.

Mr. Goodreau addressed the issue of minimum liquidity needs. This issue goes back to early 2007 when the need for cash led to the approval of a cash bucket in the asset allocation model. The need

stems from tactical reasons such as capital calls and other liabilities that the fund needs to meet. With the recent volatility, our cash bucket was the reason we did not have the forced liquidations that other funds had. As of now, we are at 2% and this should be sufficient.

Mr. Burns restated that the constraints reflect the preferences of the commission and determines where the model will come out. The optimizations show expected return and standard deviation for the various six (6) possibilities and the current portfolio. We added return for unit of risk scale, which shows that as you take on more risk you get less return incrementally, which is typically what happens in the real world.

Treasurer Caprio asked for a list of representative fund families or managers with specific examples and track records, so we can understand what type of decisions we would be considering. We would also like to see the same thing for the opportunistic portfolio.

Mr. Burns continued by stating when considering which options would work for RI the key is how much real return versus US equity. The assets have been recategorized into three buckets: stable, moderate growth and growth oriented to give you something to start thinking about conceptually in determining where you want to end up. The stable part of the portfolio stays relatively consistent. The amount that is growth oriented versus moderate growth is what

changes.

Mr. Burns restated that the goal is to achieve equity-like returns without the volatility, and that even if this policy is adopted, it will take time to get into the real return assets. This is a good goal because the current portfolio has 43% is U. S. equity and 20% is non-U. S. equity and this is a big exposure to publicly traded equity.

Ms. Gallogly questioned the issue of correlation between the non-U.S. & U.S. equity. If we did not have a constraint on non-U.S. equity on the low end of 15%, if it was lower, would it shift into the U.S. equity category?

Mr. Burns commented that it probably would but he did not how far it would go. Another element in diversification is that in ten years we do not know if non-U.S. equity or U.S. equity will perform better. We want an allocation to non-U.S. equity for that reason. Again, we want to strike some balance with risks that are accounted for. To get the discussion started a consultant might say portfolio 3 (in our case) seems to strike a reasonable balance between all considerations.

Mr. Treat noted his reaction to portfolio 3, reducing growth orientation by 10% and shifting to moderate growth, we are moving 10% of assets. In doing so, we are moving assets that have an assumed rate of return of 6% on an annual basis into a real return of 3 3/4 % reducing volatility. Does it also take away possibility of growth?

Mr. Burns stated yes, there is a trade off on return but it reduces the expected volatility of the portfolio.

Mr. Treat said the loss of growth is his concern and he, like Treasurer Caprio, would like more definition on the real return opportunities.

Treasurer Caprio asked if we could be more specific with the options being considered for the real return asset class and look at the annual return.

Mr. Costello stated he thinks that we should round up to whole numbers because the differences are so subtle. In addition, the Treasurer and staff have done a very good job managing the fund. He asked for information on fees for additional managers or products and implementation and timing issues.

Mr. Burns will supply information on implementation at the next meeting. He stated the timing issue is always going to be there, but the commission is right to want to know more about it. These changes will take a couple of quarters before money starts to roll over.

Mr. Giudici asked for more information on loss of opportunity and timing, based on the deviation of 15% in US equity.

Mr. Burns responded that most people phase in over a period of time. Under no circumstance would a recommendation be made that has to happen instantly. The next thing would be to put this into an investment policy statement that will guide all assets.

Treasurer Caprio commented that Mr. Giudici has asked and he would also request an update with any changes that have gone on around us with state or municipal funds in this area – where they have reduced exposure in certain areas and increased in others. A summary of changes instituted or being considered would be helpful.

Mr. Burns stated what we are seeing generally is the desire to reduce public equity exposure. What we are discussing is a common theme. In response to Mr. Giudici's question at a prior meeting about what others are doing in the opportunistic portfolio area Mr. Burns prepared a brief memo on other funds. This is an area of intense scrutiny where different approaches are being used. There are three broad approaches: 1.) allocate to one manager, 2.) manage in house with consultants using specialist mandate managers, 3.) allocate to various segments and manage separately within each segment.

Ms. Gallogly asked if any options would not work for us, say the last option for real estate?
Mr. Burns stated all would work for Rhode Island.

Mr. Goodreau commented that he could see this happening in private equity because our program is mature. Boards that are like ours who want to be involved pick a category where they can add value.

Ms. Gallogly asked that if we were to follow that process, would some opportunistic assets be in private equity and some be in real estate and not a separate category?

Mr. Goodreau replied that the question is do we want to be opportunistic through the other asset classes.

Ms. Gallogly asked if any options would not work for us?

Mr. Goodreau stated that there are some areas he would not recommend because they are too time consuming.

Legal Counsel Report.

Mr. Dingley stated that we received a request from the SEC to the retirement fund. It was sent out broadly to a number of major public pension funds. This follows a case where San Diego was held liable for fraud in their disclosures regarding their pension liabilities. We have shared the materials with disclosure counsel, Adler, Pollock and Sheehan. They have made some recommended changes to our public disclosures. The fifteen page detailed questionnaire also covers how the pension fund works. One area of investigation is focused on re-amortization and mark to market questions. The second aspect is

focused on placement agents. Treasurer Caprio has taken a hard line on placement agent fees. However, we suspect it was routine to pay placement agents before the Caprio administration and this questionnaire goes back five years. Once all our answers are together, we will go to outside counsel. Placement fees were industry practice and we do not know what PCG will find for prior years.

Treasurer Caprio reported that the Treasurer of Connecticut invited him to meet with her early in his term. She addressed placement fees in the meeting because Connecticut had dealt with the issue so we were alerted early on.

Ms. Gallogly asked if it is only in private equity.

Mr. Dingley replied it could be any transaction.

Mr. Goodreau noted it usually occurs where fees are easily hidden, which is private equity, hedge funds or real estate where the documents are lengthy.

Mr. Reilly asked Mr. Dingley if we have a no fee clause that we put into everything.

Mr. Dingley replied we have asked legal counsel to scour for fees and to bring it to our attention so we can say no to the fee.

Treasurer Caprio commented that we have had limited instances where this issue has been raised and in each case the fee has been deleted. We will keep the commission informed as our response is completed.

Ms. Gallogly asked if we have requested information on fees from the old managers.

Mr. Goodreau responded that we will provide the SEC with a list of all relationships we have as well as the contacts. They may in turn have to provide additional answers.

Chief Investment Officer Report. Mr. Goodreau reported to the commission that transitioning from active to passive management is complete and very successful. The transition of the domestic and international equities to index investments has been completed with costs lower than expected. We had a great month in equity and fixed income portfolios as liquidity has come back to the market. The downside is that we will see re-valuation catching up in the private equity portfolio. This will probably happen for 6 months. For the month the total equity was up almost 8% and the index was up 8.4% so we are off about 50 basis points. Because of re-valuations in private equity we were up 6%. The fund for the calendar year to date is positive after expenses.

Treasurer Caprio stated that he and Mr. Goodreau met with firms,

regarding an asset liability study, in New York.

Mr. Dingley stated that conducting an asset liability study would be critical. As we have net cash outflows in the fund of approximately $700M and we collect $500M in contributions we have a net $200M negative outflow on an annual basis. The actuaries will come in on June 30 and value the fund at market value, but because they use 5 year smoothing the impact of the adverse markets will not significantly impact contributions; only 20% of the recent bad markets will impact contributions. The pressures the negative cash flow is going to place on the fund are ever increasing. This Asset Liability firm has a unique approach because they project on a true economic basis.

Mr. Costello asked if this is our problem or if it is a legislative issue because it is about the funding.

Mr. Dingley replied that he thinks it is both an SIC and legislative issue.

Treasurer Caprio stated there are many things involved, monthly payments, budget issues, the 30-year amortization, in quantifying where we need to be in asset allocation. This is a good time for review because of upcoming legislative changes.

Mr. Costello asked if they provide alternate assumptions of the future levels of the market and future negative cash flow impact?

Mr. Dingley stated it is a changing landscape; there could be legislative changes that cause another rash of retirements.

Mr. Giudici stated that we need to be prudent in asset allocation even though we are exempt from ERISA.

Treasurer Caprio proposed that we have the firm come in to meet with the board in a sub-committee setting. If there is an interest in engaging them or someone else, we can start with RFPs.

Treasurer's Report. Treasurer Caprio requested, in the interest of time, that his report be considered interwoven in the Legal Counsel and CIO reports.

New Business. There was not any new business.

There being no new business, the Treasurer entertained a motion to adjourn. Mr. Giudici moved, Mr. Reilly seconded and the subsequent motion passed. The following members voted in favor: Mr. Costello, Ms. Gallogly, 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

10:38AM.

Respectfully submitted,

Frank T. Caprio

General Treasurer