State of Rhode Island and Providence Plantations

STATE INVESTMENT COMMISSION

Monthly Meeting March 24, 2010

A State Investment Commission (SIC) meeting was held in Room 135, State House, Providence, Rhode Island on Wednesday, March 24, 2010. The Treasurer called the meeting to order at 9:04 a.m.

Membership Roll Call. Present were: Ms. Rosemary Booth Gallogly, Mr. Michael Costello, Mr. Robert Gaudreau, Mr. Robert Giudici, Ms. Marcia Reback, Mr. Andrew Reilly, Mr. John Treat and General Treasurer Frank T. Caprio, establishing a quorum. Also present were: Ms. Sally Dowling, of Adler Pollock, & Sheehan and Mr. Joseph Rodio, 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; Mr. Nick Katsikis of State Street Corporation; and members of the Treasurer's staff. Dr. Robert McKenna was not present.

State Investment Commission Minutes. Treasurer Caprio entertained a motion for approval of the minutes for the meeting of February 24, 2010. Ms. Booth Gallogly moved, Mr. Reilly seconded, and the subsequent motion passed. The following members voted in favor: Ms. Gallogly, Mr. Costello, Mr. Gaudreau, Mr. Giudici, Ms. Reback, Mr. Reilly, Mr. Treat and Treasurer Caprio.

VOTED: To approve the Minutes of the February 24, 2010 monthly meeting.

General Consultant Report. Mr. Burns asked the group to refer to the handout "2010 Fixed Income Review." He started the presentation by stating that fixed income has undergone a difficult period over the past 2 years and in general, it was not the diversifying asset most expected it to be. Today we will start the discussion of what the changed interest rate environment will mean long-term for the policy and what role the 22 to 25% of the pension portfolio in fixed income will play in the fund among the diversified asset classes. He explained that the role of fixed income could be: for diversification, a principal protector, a value added asset or to match liabilities. He then reviewed some of the characteristics of each role.

Mr. Burns stressed that fixed income markets are undergoing dramatic changes. There is no clear industry consensus on how an investor like Rhode Island should structure the fixed income portfolio.

Mr. Emkin commented that fixed income portfolio management has evolved over 25 years. Years ago there was 1 benchmark, the Lehman Government-Corporate Index, which was composed of only high quality bonds. Over the years bond portfolios have taken on more risk as they added components because the Government did not sell as many bonds. The government sector shrunk as the corporate sector expanded in the index, therefore the industry became more

driven by credit risk. In 2007/2008 that blew up. The result was that fixed income did not do what it was traditionally supposed to do, which is to diversify risk of equities. The SIC should consider this point of reference when they consider the strategic decision of what they want fixed income to do in the future.

Mr. Burns continued by saying that the primary factors that drive returns are interest rates and credit risks. He explained the key fixed income concepts are duration, convexity, yield curve structure and credit risk. He said that duration is of primary importance. The calculation of duration is the sensitivity to interest rates for a bond or a portfolio. He then reviewed an example on page 10 in the handout. He noted that duration of the benchmark for the RI portfolio is about 4.7 years, while the duration of liabilities is about 13 years. Generally benchmarks have gotten broader as the number of potential investments available has grown.

He then turned to an overview of the composition of the U.S. bond market, noting that mortgages take up a large part of the space, but that this will change as the government issues more bonds. He asked the group to refer to page 19 for a snapshot of the characteristics of the Rhode Island portfolio's benchmark. He pointed out the 4.57 duration means that if interest rates move up or down 1%, then the portfolio will move up or down about 4.5% and the average (credit) quality is very, very high with 81% being backed by the US Government. The SIC should keep this snapshot in mind when they consider the objectives and the benchmark for the fixed income portfolio.

Mr. Goodreau commented that there will be massive amounts of debt coming into the market but that the SIC can't let supply lead their decision making. The question is how the board will approach that debt. This period of time is so different from anything that has been seen, the SIC can't just look at the indexes and past performances. Mr. Goodreau commented that Mr. Burns' input is very important.

Mr. Emkin said recent returns are not likely to happen again. Over the past 10 years bonds had a positive return and stocks were flat, while during the previous 10 years that was not the case. There has been a 25 year period where interest rates have gone down and the new generation on Wall Street has no point of reference.

Mr. Burns said that is part of a structural review of fixed income starting with a definition of policy, manager reviews and how it will be implemented to meet the goals. The focus going forward is on what the board wants the role of fixed income to be that is not being provided elsewhere in the portfolio. Depending on the role the make-up will be different.

Ms. Reback asked if the roles are mutually exclusive.

Mr. Emkin stated that it is not black and white; there could be an orientation towards one role and have elements of another.

Treasurer Caprio asked if there were any comments on the market in general.

Mr. Emkin commented that the world markets are changing swiftly. A short time ago the view was that the dollar was dead, yet there has been a rally in the dollar – as people around the globe have sold the Euro and the Yen and bought U. S. dollars. The focus in public

pension plans, for the first time, is on their financial condition and the liabilities of the plan rather than investments.

Treasurer Caprio mentioned that Rhode Island has been focused on this issue for some time and has made reforms to bring liabilities down.

Educational Series. Treasurer Caprio introduced Mr. Robert Cusack of Newport Investment Management.

Mr. Cusack introduced his colleagues Mr. Earl Chambers, Mr. Werner Keller and Mr. Matthew Lenehan with a brief career summary. He then gave an overview of the firm and their idea to go beyond the traditional strategic asset allocation and diversification benefits of index investing and really try to find a systematic way to address portfolio risk. He stated that risk control has come to the forefront of the institutional investing community and they are pleased to provide an overview of risk control and its benefits. He then turned to Newport Investments' research advisor, Mr. Keller, noting the Keller model is used to manage over $100,000,000 of assets.

Mr. Keller asked the group to turn to page 6 of the Newport Risk Control Advisory Overview to illustrate the problem of draw down with the Standard & Poors index of the last 40 years that routinely draws down 30% from the high. He said that returns from equities, in addition to being very noisy, also are delivered in spurts which are illustrated in the Dow Jones graph on page 7.

He continued stating that return is almost 10 times larger than the contribution of the manager, if you attack systematic risk partially,

the rewards would be fairly significant, maybe enough to offset the frictional cost of the management process. Markets have a propensity to trend. There are some seasonal inefficiencies: the second half of the year tends to be weaker than the first half and that is statistically significant, and there's a presidential cycle, which is also statistically significant. The inefficiency that drives the model is trend persistence, what is also called momentum effects. The model has all of these internal market items in it. This is not trying to alter the behavior of the S&P; it takes the S&P and just puts a control on it. He asked the group to turn to page 11 and gave an overview of the Keller Equity Trend Model.

Mr. Cusack commented that he was particularly interested if the model can identify the downtrends so that the SIC protects itself during those periods.

Mr. Costello asked if this is a static model or if they are constantly looking at new inputs and tweaks to the model.

Mr. Keller said that it's static, and that's very important. He stated that he does look at new things but that he always keeps the original one that's dated 12/31/2004 in place. The model has flexible parameters, it has envelopes that widen when volatility widens. It has moving averages that move around so it does try to flex with change in market conditions. He reviewed several charts illustrating various aspects of the model.

Mr. Reilly asked if some signals are stronger than others.

Mr. Keller said that no, he has forced it into a red or green format, it just follows the money.

To summarize, he said that the model is a series of inputs to the extent thye SIC has indexed S&P exposure. This is a harness that could ride on top of that S&P exposure, and encourage the SIC to increase it or decrease it, to some extent. Mr. Keller said that it's a statistical process and it simply responds to the movement of money and the pressure of demand and supply inside the marketplace.

Secondary Opportunity Review. Ms. Davidson began the by telling the group that PCG would recommend the consideration of another secondary sale. Given the successful sale of June 2008, the thought was to continue to evaluate opportunities to sell as appropriate. With the market dislocation and resulting decline in the public markets in the interim, the private equity portfolio is now exceeding targets.

She asked the group to look at first page of the Rhode Island Secondary Transaction Update. She explained that the SIC target is 7.5% and that now the actual is around 9.8% for the private equity allocation relative to total pension assets. Given that the portfolio exceeded the target, it was natural to think of selling funds to manage down exposure, but the distress and uncertainty in the market impacted prices during the second half of 2008 and 2009 to the point where discounts were as much as 40 to 60%. For a non-distressed investor such as RI, it was better not to sell in that environment. Starting in 2010, private equity valuations have been stabilizing, and less market uncertainty has led to improved pricing, with discounts now in the 20 to 25% range and in some cases up to 15%.

Given the improved pricing environment, it was suggested that the

board start looking at another potential secondary sale which will lower the exposure to private equity, reduce unfunded liabilities and allow a rebalancing of the portfolio.

A majority of unfunded liabilities within private equities lie in 2006 commitments in the large and middle market buy out space. Those were appropriate investments at the time, but now strategies are needed that are better positioned to take advantage of the current environment to be of maximum benefit to the portfolio return and have a shorter time to liquidity. Some of those sectors include distressed or secondary strategies.

Mr. Costello stated the he is surprised that we are this much out of line given that this asset class over the last few years has done relatively nothing if not declined. He asked if the $639 million was the committed amount but unfunded.

Ms. Davidson replied that this is actually the net asset value, so it is the fair market value of the assets and doesn't include the unfunded.

Mr. Goodreau said that: we were only close to target when we had the reverse denominator effect, but we have always been somewhat over allocated.

Treasurer Caprio commented that we are under in real estate so the blend kept us under 12%.

Mr. Costello asked how confident PCG is with the fair market value.

Ms. Davidson replied that we are confident, but it is reported on a lagged basis. This is as of September 30, 2009. Values have increased since then.

She continued, saying that we have designed sale options from $50

to $200 million for the board's consideration, with the larger end bringing exposure more in-line, all things being equal. If the proceeds of the sale are redeployed into appropriate areas, over the long-term the overall performance would increase versus the status quo. The sale over the short-term would have a minor negative impact on performance given the discount, but our estimates show that after three years the performance would be higher with the sale than without. She then reviewed graphs of the various scenarios' impact on allocation. She pointed out that with the $100 million sale scenario, even if proceeds were redeployed, the fund would be nearer target, have better vintage diversification and be rebalanced. Another factor is the impact on cash flow – a sale would have an immediate positive impact on cash flow, and would remain cash flow positive. The key is to reinvest in strategies that have a shorter time to liquidity and earlier distributions over the near term.

She then asked the board to turn to a list of the potential offerings and explained that the SIC is creating an opportunity with a small subset of private equity buyers so the SIC can get the best pricing and combination for the portfolio. The focus is on large buyouts and medium buyouts to manage down that exposure to funds where the investment pace is slower and there is already adequate capital or "dry powder" available for investment. The most likely scenario, to get the most attractive pricing and most positive impact for the portfolio, will be a sale between $50 and $100 million that would consist of about half cash and half would be a reduction in unfunded liabilities. The purpose of this presentation is to start the discussion

on the topic of another secondary sale and to give a sense of some of the opportunities and parameters.

Treasurer Caprio entertained a motion to allow the staff and consultants to explore a secondary sale to rebalance the portfolio subject to board approval. Ms. Reback, moved, Mr. Costello and Mr. Treat seconded, and the subsequent motion passed. The following members voted in favor: Ms. Gallogly, Mr. Costello, Mr. Gaudreau, Mr. Giudici, Ms. Reback, Mr. Reilly, Mr. Treat and Treasurer Caprio.

VOTED: To allow the staff and consultants to explore a secondary sale to rebalance portfolio subject to board approval.

Legal Counsel Report. Legal Counsel had no report.

Chief Investment Officer Report. Mr. Goodreau reported that the portfolio value is over $7 billion based on recent market activity.

Mr. Costello asked about the status of regular manager reviews.

Mr. Goodreau commented that he and Mr. Burns have done a full review of fixed income. All the managers came in to answer questionnaires. They concentrated on fixed income because this is the area where most of the active managers are. They will present information on each manager and how they look at the entire program in the future.

Treasurer's Report. Treasurer Caprio told the group that at the next meeting there will be a presentation regarding the renewal of the

Alliance Bernstein - 529 Plan contract. This board and the Rhode Island Higher Education Assistance Authority (RIHEAA) have joint responsibility in the 529 Plan. Alliance Bernstein currently handles the 529 investments, which are a number of mutual funds, where RI residents can manage their college savings. The Alliance Bernstein contract is due to expire. There have been full active negotiations between RIHEAA, Treasury and Alliance Bernstein staffs. As a condition of renewal the Treasurer has insisted that Rhode Island families have the lowest fees charged on investments of any State in the country. Additionally, the funds that come into RIHEAA for scholarships for Rhode Islanders would increase by approximately 50%.

New Business. There was no new business.

There being no new business, the Treasurer entertained a motion to adjourn. Ms. Reback moved, Mr. Reilly seconded and the subsequent motion passed. The following members voted in favor: Ms. Gallogly, 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 11:38 a.m.

Respectfully submitted,

Frank T. Caprio

General Treasurer