State of Rhode Island and Providence Plantations

STATE INVESTMENT COMMISSION

Monthly Meeting June 23, 2010

A State Investment Commission (SIC) meeting was held in Room 135, State House, Providence, Rhode Island on Wednesday, June 23, 2010. The Treasurer called the meeting to order at 9:03 a.m.

Membership Roll Call. Present were: Ms. Rosemary Booth Gallogly (arrived at 9:06), Mr. Michael Costello, Mr. Thomas Fay, Mr. Robert Gaudreau, Mr. Robert Giudici, Ms. Marcia Reback, Mr. Andrew Reilly and General Treasurer Frank T. Caprio, establishing a quorum. Also present were: Ms. Sally Dowling, of Adler Pollock & Sheehan, and 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 Consultant to the Commission; Mr. Nicholas Katsikis of State Street Corporation, Ms. Michelle Davidson and Mr. Scott Reinig of Pacific Corporate Group, 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 May 26, 2010. Mr. Costello moved, Mr. Fay seconded, and the subsequent motion passed. The following members voted in favor: Mr. Costello, Mr. Fay, Mr. Gaudreau, Mr. Giudici, Mr. Reilly and General Treasurer Caprio.

Ms. Reback abstained.

VOTED: To approve the Minutes of the May 26, 2010 monthly meeting.

General Consultant. Mr. Burns asked the board to turn to the handout 2010 Fixed Income Review – Part III which has further background and options to consider for future policy decisions on the structure of the fixed income portfolio. He then reviewed the current RI fixed income portfolio and contrasted it to the Barclay's Capital Aggregate Index as a point of reference. He highlighted the fact that currently there is a sizable allocation to corporate credit risk, through the investment grade and high yield portfolios, for future allocation consideration.

He continued by stating that the fixed income portfolio is important in the context of your total portfolio, because of correlations. Treasury and mortgage-backed securities have lower correlations with equity than investment grade bond and high yield bonds. When equities are performing poorly, fixed income is a defense to negative returns. He then reviewed graphs that illustrate the correlations of the various segments of the fixed income market compared to the Russell 3000. He pointed out that the high yield market and investment grade bonds have a fairly high correlation. However, with governments and mortgages there is actually a negative correlation. That's good, because it's a risk reducer.

Mr. Emkin noted that the traditional role of fixed income is to diversify the risk of equities and to provide a source of cash flow. In 2008, universally amongst PCA's clients, it did not provide a hedge because of the exposure to credit. Because fixed income did not accomplish the goal of diversification, institutional investors are seeking better ways of looking at this asset class.

Mr. Burns commented that there is data in the appendix supporting Mr. Emkin's comments. It is very important for this board to set policy for corporate and high yield investments and not leave this decision to managers. He then asked the group to turn to page five of the handout for a review of the sectors similar to that of Rhode Island's fixed income. A U. S. Treasury - Agency manager (only) historically has not added value because this is typically a very efficient market. The policy implication is: nothing is to be gained from active management, so index that segment.

Managers in the mortgage-backed area vary in outperforming the benchmark after fees in this fairly efficient segment. The policy consideration is to focus on a specialist manager. Historically corporate managers have added value after fees as do high yield managers. In these segments there are opportunities to add value by taking active management risk.

Mr. Emkin commented that it is important to remember that active management risk in fixed income doesn't mean more volatility.

Mr. Burns then reviewed the traditional structure of active management and its benefits and liabilities. He stated that in this case

there would be four core managers, or four core plus managers, that would get value added out of sector rotation. With the segmented portfolio, currently employed, there is not an opportunity for this model. He then reviewed passive management where the fixed income portfolio could be indexed in entirety or in portions.

Treasurer Caprio asked Mr. Emkin for his thoughts on how the active fund manager returns compare to the index returns.

Mr. Emkin stated that net of fees the market is pretty efficient and not only will the board need to pick the right managers but those managers need to do well to beat the index net of costs and fees over the long term. The challenge as policy makers is that you need try to project if the past is any indicator of the future or if there will be a different market environment.

Mr. Burns detailed four fixed income alternative structures with varying uses of passive and active management. He noted that portfolio D is a new model in which corporate and high yield could be part of a long/short strategy.

Mr. Goodreau commented that his view of fixed income is in two parts: one that's designed to protect the money with a guaranteed rate of return in the market and the other which is like an equity component to try and add value; therefore, portfolio D would be attractive in a modified extreme barbell structure.

Mr. Burns remarked that the board could structure this portfolio in many ways to effectuate the policy view. In this scenario, the board would be responsible for sector weight management.

Mr. Emkin observed that generally speaking bond managers aren't

managing risk as much as they're managing return. Their goal is to beat the benchmarked return and they might be willing to accept a much higher level of risk than the board. Risk should weigh into the policy consideration.

Mr. Burns concluded his presentation by addressing the current manager performance that was previously requested by Ms. Booth Gallogly. He stated that the snapshot of the last 10 years, after fees, shows: Brown Brothers below the benchmark by 30 basis points, Pyramis is right on the benchmark, TCH is 13 basis points above the benchmark and Mackay, over the seven years since inception, added 90 basis points to the benchmark.

Mr. Fay asked that PCA provide additional information on the standard deviation, the risk side of the equation and what value was provided by the current managers.

Mr. Goodreau noted that the fund is getting index like returns with the uncertainty of potential overweight risks.

Treasurer Caprio asked that PCA come back with information on costs and options to continue the discussion.

Mr. Dingley stated that he would like to see an analysis of an inflation scenario with interest rate increase to determine what impact it potentially would have on the historical analysis.

Mr. Emkin concluded by commenting that the past five years fund performance has been outstanding. Relative to your peers, Rhode Island is in good standing. The board, the treasurer's office, and the staff deserve a tremendous amount of credit. Looking back at a longer period of time the assets weren't as well managed and the

performance wasn't as good. When making decisions about future policy, keep in mind the world has changed; it has become a much more volatile place with many uncertainties out there. Now is the time to be very cautious and attentive to monitoring all your positions. Mr. Emkin stated that he doesn't know of any of PCA's clients that are making major moves and they are being less risk inclined.

Legal Counsel Report. Legal Counsel had no report.

Chief Investment Officer Report. Mr. Goodreau stated that he agreed with Mr. Emkin's statement that the board's primary responsibility is to be prudent with these assets. The long term annualized averages across the board show strong relative results. The year to date number is 190 basis points above the benchmark for the fiscal year, the one year number 230 basis point above the benchmark, a two year number 250 basis points ahead, a 3 year number about 180 basis point ahead, and a 5 year number 40 basis point ahead. Additionally, the portfolio has a reduced risk factor and the standard deviation is now down close to 11. It is also important to recognize that, in November of last year, the board made a policy decision to reduce the exposure to international equity from just over 20% to 17.5 %. Focusing on asset allocation and cutting fees has resulted in a relatively more conservative portfolio that is performing far better.

The hedge fund sub-committee met to review the summary of the vast data that our consultants have processed over the past few months. Present were Mr. Costello, Mr. Fay, Mr. Reilly, Treasurer

Caprio, Mr. Goodreau, and Mr. Burns. Mr. Sandswich of PCA joined the meeting by phone conference. The consensus was that the hedge fund universe should feature high single to low double digit type returns, a significantly low standard deviation consistent with return and low fees. For the next meeting, the sub-committee will review recommendations of what the hedge fund portfolio structure may look like.

Treasurer's Report. Treasurer Caprio asked the group to turn to the PCG Private Equity Portfolio Report – Fourth Quarter 2009 and asked Ms. Davidson to briefly review the year end 2009 data.

Ms. Davidson stated that the report is based on year end, audited numbers, from all managers. The trend has been upward since first quarter 2009. Returns are up 20 % which gives the portfolio a since inception rate of return of 14.4 % as of year end, beating the S & P 500 plus 300 basis points, your relative benchmark which was about 9.4%.

Mr. Costello asked about the level of credit that is currently available in the private equity market.

Ms. Davidson stated that it varies by sector, with bank and high yield debt being fairly available to finance large transactions. However, at the smaller end of the market and within the middle market, financing is still difficult to get. This creates an opportunity, however, for investing in strategies that provide liquidity, such as mezzanine debt strategies.

Mr. Reinig noted that now there are more restrictions in place on the debt that private equity firms receive, such as more covenants, than during the credit bubble.

Treasurer Caprio asked Mr. Goodreau to give an update on the secondary sale the board approved in March.

Mr. Goodreau commented that the transaction has been completed and it is a matter of waiting for checks to arrive, the majority of which should be in hand later this month. He noted that again, the timing was ideal and he thanked Ms. Davidson for her efforts.

Treasurer Caprio closed by noting that the PCG contract is due to conclude and it will be on the agenda for the July meeting.

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. Booth Gallogly, Mr. Costello, Mr. Fay, Mr. Gaudreau, Mr. Giudici, Ms. Reback, Mr. Reilly and General Treasurer Caprio.

VOTED: To adjourn the meeting.

There being no further business, the meeting was adjourned at 9:55 a.m.

Respectfully submitted,

Frank T. Caprio

General Treasurer