

State of Rhode Island and Providence Plantations

STATE INVESTMENT COMMISSION

Monthly Meeting July 28, 2010

A State Investment Commission (SIC) meeting was held in Room 135, State House, Providence, Rhode Island on Wednesday, July 28, 2010. The Treasurer called the meeting to order at 9:03 a.m.

Membership Roll Call. Present were: Mr. Michael Costello, Mr. Thomas Fay, Mr. Robert Giudici, 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. John Burns of Pension Consulting Alliance (PCA), General Policy Consultant to the Commission; Mr. Nicholas Katsikis of State Street Corporation, Mr. Scott Reinig of Pacific Corporate Group, and members of the Treasurer's staff. Ms. Rosemary Booth Gallogly, Mr. Robert Gaudreau, 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 June 23, 2010. Mr. Costello moved, Mr. Giudici seconded, and the subsequent motion passed. The following members voted in favor: Mr. Costello, Mr. Fay, Mr. Giudici, Mr. Reilly and General Treasurer Caprio.

VOTED: To approve the Minutes of the June 23, 2010 monthly meeting.

General Consultant Report. Mr. Burns asked the board to turn to the handout 2010 Fixed Income Review – Part IV. He stated that he would review background material, which addresses some questions raised last month, PCA’s recommendation and rationale for this proposal and supporting documentation in the appendix.

He then reviewed page three, which is the current Rhode Island portfolio, and page four, which addresses the issue of interest rate sensitivity that Mr. Fay raised. He commented on the general impact to the portfolio if interest rates move 100 basis points either up or down. He stated that the duration of this portfolio is about 4.6 years and the yield to maturity is roughly 3.5%, which is very similar to the aggregate bond index. He then addressed the performance of current managers, stating that in addition to not adding much value, they did not offer increased risk protection over the benchmark.

Mr. Burns stated that the fund is currently using a hybrid sector approach plus one traditional core manager. The recommendation is to use a sector approach removing high yield from fixed income and placing it in the Opportunistic Portfolio. The Fixed Income portfolio would consist of U.S. Treasury, Mortgage and Investment-grade Credit broken up into three sectors. Additionally, the recommendation is that the Treasury and Mortgage sectors would be passively managed because there is little a manager can do to add

value in those sectors.

For the Credit sector, triple B or better, active management is recommended. The sector weight would be 40 – 40 – 20, which keeps the portfolio heavily weighted in government backed securities. For the High Yield Sector in the Opportunistic Portfolio, we propose active long – short managers.

Mr. Burns then discussed page nine which covered manager activities. He explained what is allowed under the current structure and would be allowed under the proposed structure for interest rate anticipation, yield curve strategy, security selection and sector rotation. He continued with a chart on page ten that shows where the value added or alpha return is derived from in the current and proposed structures. He stated that the current expected alpha return is 27 basis points and the proposed structure is 20 basis points. He pointed out that the new structure doesn't include the high yield sector that will be moved to the opportunistic portfolio that is the long-short part of the overall portfolio which is where the fund is supposed to get alpha returns.

Mr. Burns provided the supporting rationale for the proposal stating that there would be a clear delineation of risk factors; the board would set the risk and return preferences, the focus of genuine active management would be in the most inefficient sectors and cost management would be enhanced. Fixed income provides the anchor for the rest of the portfolio; the other parts of the portfolio have a lot of growth opportunity.

Mr. Goodreau commented that fixed income fees are relatively high.

Currently the fund pays fees for services that are not producing alpha. Under this structure, the focus would be on paying for management where alpha can be achieved.

Mr. Burns then detailed the proposed structure stating it would be focused on publicly-traded U.S. Fixed Income. It would exclude Commercial Mortgage-backed Securities (CMBS), private Residential Mortgage-backed Securities (RMBS) and Non-U.S. Fixed Income. The excluded segments would be handled in the Real Estate and Opportunistic Portfolios. He concluded by stating the next steps in this process would be to: adopt a Fixed Income Policy Portfolio, an Investment Policy Statement, Sector structure and management guidelines and hire managers.

The group proceeded to discuss Mr. Burns' presentation and general fixed income matters.

Mr. Goodreau commented that an important part of this structure is to give managers flexibility to address risk in the event of a dislocation that is likely to occur, at some future point, after a 25 year bull credit market.

Mr. Costello stated he thought the managers had done a pretty respectable job and inquired if the recommendation is hiring a new group of managers or issuing new guidelines to current managers.

Mr. Burns asked the board to turn back to page eight for clarification. The board completed the discussion of performance and risk and then turned to the issue of timing.

Mr. Fay asked what type of transition and/or time frame is suggested.

Mr. Burns commented that transition would be a policy decision that

would require a review of the mitigating factors. He stressed the overriding consideration is the policy.

Mr. Goodreau said the transition depends on the comfort level of the board though once a policy is set a move to it should be prompt. The reason we are engaged in this review is because fixed income is likely to be a dynamic sector in the future.

Treasurer Caprio stated that this item is very important as the policy will impact 20% of the portfolio. He would like to continue the discussion next month considering the level of input and the fact that some members of the board are absent.

Legal Counsel Report. Legal Counsel had no report.

Chief Investment Officer Report. Mr. Goodreau stated that the return for fiscal year 2010 ended just under 13.6%. This puts the fund 220 basis points over the benchmark, 120 basis points over the 2 year benchmark, and 70 basis points over the 3 year benchmark. In every average time period the fund is beating its benchmark, because of efficiencies and exposure. He noted that the fund performance is 200 basis points over CALPERS and 150 basis points over CALSTERS.

He continued stating that the move to the passive mandate enabling the board and staff to focus on important issues is confirmed in these returns. Right now the correlation of (individual) stock movement to the stock market, the S & P 500, is 83%. This means the current environment is not about a market of individual stocks, but the stock market itself, which has not been the case except one other time in

1987. Consequently, making risk decisions right now is very difficult, so the critical decision is either to be in the market or out.

He told the group that currently the market is at about the halfway point in recouping the damage from the 800 point decline in 2008.

He reported that the \$100 million sale of private equity has been successfully completed at one of the lowest discount rates available recently. He noted that the low discount no longer exists at this time.

Treasurer's Report. Treasurer Caprio stated that it is very good for Rhode Island to be in the top quartile of funds. He commended the board and staff for the work that has been done to place Rhode Island in the top rankings, outperforming CALPERS and CALSTERS, the biggest funds in the country.

New Business. There was no 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. Michael Costello, Mr. Thomas Fay, Mr. Robert Giudici, Mr. Andrew Reilly and General Treasurer Frank T. Caprio.

VOTED: To adjourn the meeting.

There being no further business, the meeting was adjourned at 9:58 a.m.

Respectfully submitted,

Frank T. Caprio
General Treasurer