



State Investment Commission
Monthly Meeting Minutes
Wednesday, September 25, 2013
9:00 a.m.
Room 205, State House

The Monthly Meeting of the State Investment Commission (SIC) was called to order at 9:03 a.m., Wednesday, September 25, 2013 in Room 205, State House.

I. Roll Call of Members

The following members were present: Mr. J. Michael Costello, Mr. Thomas Fay, Ms. Paula McNamara, Mr. Thomas Mullaney, Ms. Marcia Reback, Mr. Frank Karpinski, and General Treasurer Gina Raimondo. Mr. Robert Giudici arrived at 9:11 a.m.

Also in attendance: Mr. Darren Lopes and Mr. David Wonn of TIAA-CREF; Ms. Jennifer Delong, Mr. Christopher Nikolich, Ms. Patricia Roberts, and Mr. Vadim Zlotnikov of AllianceBernstein 529 fund manager for the State; Mr. David Blanchett of Morningstar Investment Management; Mr. Steve Nesbitt and Mr. Mark Johnson, of Cliffwater, alternative investment consultant to the Commission; Mr. John Burns of Pension Consulting Alliance (PCA), General Consultant; Ms. Susan Leach DeBlasio, of Adler Pollock, legal counsel; Mr. Charles Kelley and Ms. Gail Mance-Rios of Rhode Island Higher Education Assistance Authority (RIHEAA); Ms. Anne-Marie Fink, chief investment officer and members of the Treasurer's staff; Members of the House and Senate fiscal staff and various local reporters. Mr. Andrew Riley was absent.

Treasurer Raimondo called the meeting to order at 9:03 a.m.

II. Approval of Minutes

On a motion by Ms. Reback and seconded by Mr. Mullaney, it was unanimously

VOTED: to approve the draft of the minutes of the July 24, 2013 meeting of the State Investment Commission. Mr. Giudici was not yet present.

A motion was then made by Ms. McNamara and seconded by Mr. Mullaney it was

VOTED: to approve the draft of the Executive Session minutes of the July 24, 2013 meeting.

Ms. Reback abstained from voting on this item as she had not reviewed the minutes. Mr. Giudici was not yet present.

II. Defined Contribution Plan Quarterly Update

Mr. Lopes briefly reviewed plan demographics as of June 30, 2013. He said the plan had approximately \$122,000,000 at the end of June. He said about 93% of the funds are in the Vanguard Target Date Funds. He added that these funds will soon move into a collective investment trust with Vanguard which will save about 0.05% to 0.06% on average. He said this change will be communicated to participants in the coming weeks.

Mr. Lopes reviewed the on-site and one-on-one meetings. He said TIAA-CREF is hoping union leaders will send out communications regarding the plan regardless of what happens in mediation.

Treasurer Raimondo said the Retirement board will help with getting the word out about educational meeting opportunities and information will be included in the Retirement quarterly newsletter.

Mr. Lopes said TIAA-CREF is also making an effort to meet with plan administrators throughout the state and also trying to reach out to business managers to meet with participants.

Mr. Wonn reviewed the performance of the plan. He said the target-date funds modestly underperformed the benchmarks for the one year period. He attributed that to Vanguard going through a benchmark re-evaluation across a large number of their funds. He said the Vanguard performed well in comparison to other life-cycle strategies.

III. CollegeBound Fund Review

Ms. Fink briefly reviewed the recommendations made by Mr. Jeremy Thiessen of PCA regarding the CollegeBound Fund. She said the recommendations were: to replace some of the underperforming funds in the active glide paths that Alliance Bernstein offers, to replace some of the underperforming individual funds, to add an inflation-protected option for participants who customize their plans, to add passive glidepaths, and to hire a consultant to assist with ongoing monitoring of the plan.

Ms. Fink said Alliance Bernstein is working on four of these recommendations. She said that in order to hire a monitor, RIHEAA is working on an RFP so that will take some time. She said that the change that is the most complicated is the swapping the underlying funds within the active glide paths. Therefore this recommendation will come at the next meeting.

Ms. Nikolich reviewed AllianceBernstein's recommendations of replacements for the underlying funds and for an inflation-protected option.

Ms. Delong reviewed the recommendation of adding passive age-based portfolios. She said AllianceBernstein has been in discussion with Morningstar Investment Management to offer a co-branded, passive, age-based portfolio where they would be exclusively licensing and replicating a new 529 index glide path series. She said AllianceBernstein would manage the underlying asset classes. She noted it would be an exclusive arrangement that would make it a unique offering to CollegeBound Fund.

Mr. Blanchett gave a brief overview of Morningstar Investment Management. He described the strategy for the glide path and Morningstar's expertise.

Ms. Delong said it is a priority to have low-cost investment options for Rhode Islanders. She said AllianceBernstein proposes that this option be offered at 0.16%. She said the active glide path is offered at 0.20%, so the passive option would be at a very competitive rate.

Ms. Roberts asked the board for approval to continue discussions with Morningstar and continue the changes.

Treasurer Raimondo asked what the timeline would be to offer these options to participants.

Ms. Roberts said a potential timeframe, without committing to it, would be somewhere in the first quarter of next year.

Ms. Fink added that the SIC as well as the RIHEAA Board have to approve the changes.

On a motion by Mr. Fay and seconded by Mr. Mullaney, it was unanimously

VOTED: to approve the recommendations on page 7 of the presentation including the addition of a treasury-protected fund to the CollegeBound offerings, the replacement of individual funds, and the continuation of discussions with Morningstar regarding the passive glide path options, pending approval from RIHEAA.

IV. Private Equity Review

Mr. Johnson talked about performance for the first quarter of 2013. He said private equity generally lagged the U.S. equity market. He said it was due to a strong period of public equity returns. He said because private equity reporting tends to lag. Cliffwater would expect to pick it up in future quarters as peer comparison valuations roll through the private equity portfolios. He said the diversification in private equity has been beneficial to the construction of Rhode island's portfolio.

Mr. Johnson reviewed the goals and strategy for the private equity portfolio. He said Cliffwater has recently looked to add more in the small buyout space and lower the large buyout exposure of the portfolio. He said they are also currently working on adding some private debt exposure and lowering the venture capital exposure which had been higher in the past.

Mr. Johnson reviewed the long-term performance of the portfolio. He said long-term performance was good and has exceeded the venture capital benchmark. He said 1.46 times paid-in capital has been returned.

Mr. Nesbitt added distributions exceed the drawdowns. He said for the first time in a long time there is net outflow and a reduction in unfunded commitments.

Mr. Johnson reviewed the first quarter performance. He said distributions have been about \$27,000,000 versus about \$7,000,000 in contributions. He said the return for the quarter was 2.1% for the portfolio.

Mr. Johnson reviewed some of the drivers in performance for the first quarter. He said there has been a pick up especially in the U.S. as public equity prices have risen. He said there will be a lag effect but those valuation increases will flow through to the private equity portfolio.

Ms. Fink asked how soon this was expected to happen.

Mr. Nesbitt said that statistically it takes three quarters for it all to work through.

Mr. Johnson also reviewed the negative drivers in performance. He said the European market continues to be challenged.

Ms. Fink asked if the fact that the venture capital benchmark has not been great is due to particular funds or if it consistent across the sector.

Mr. Johnson said it is consistent across the sector and that the venture capital benchmark has had a difficult last decade particularly due to dry IPO market. He said it has been the poorest performing sector within private equity overall. He said that in the past couple of years they have seen more capital flowing into the space and at the same time the amount of capital the funds have raised has dropped dramatically. He said they believe that a lower level of capital coming into the sector should help returns over the long term.

Ms. Fink asked if the European buyout is consistent across the sector.

Mr. Johnson said it is consistent. He said, in general, European buyout funds have done poorly more recently.

Mr. Johnson went on to review the top distributions and contributions. He also reviewed the fund exposures. He reviewed the diversification by strategy and sector.

Mr. Nesbitt added that overall, the portfolio is meeting the return goals and it is well diversified. He said they are trying to concentrate the number of general partners over a longer period of time and only selecting top quality general partners. He said they would like to establish a consistent pace of new commitments.

Treasurer Raimondo asked how many more commitments they should look to do for this year.

Mr. Johnson said probably another three commitments at roughly \$20,000,000 per manager.

V. Investment Policy Update

Ms. Fink presented the board a draft of the investment philosophy and the corporate governance philosophy. She said these were only two parts of the working investment policy draft and that more parts will be worked on and presented to the board in the future. She reviewed the investment policy draft. She said the draft talks about how the plan needs to balance risk and return and it also needs long-term appreciation and short term cash flows when investing. She said the philosophy talks about the value of diversification as one of the most powerful tools of getting return per unit of risk taken.

Ms. Fink went on to review the corporate governance philosophy draft. She said the basic philosophy is guided by the character of the fund. She said there are two salient attributes. One, all of the plans equities are held through commingled funds. She said given that and limited staff, the role of the board would be oversight of managers in how they invest and how they leverage the corporate governance asset. She said the other key attribute is that in long-only equities, the plan has passive allocation. She said with passive allocation the board can't elect to not be in a company because it believes that management is destroying value. She said this puts a greater emphasis on making sure that every company is taking full advantage of the assets that the company has in generating value. She said the intent is to hold managers responsible for making sure the plan is getting value from good corporate governance. She said the draft also outlines some of the principles for long-term shareholder value. She invited the board to give their input after they've reviewed the document.

VI. Legal Counsel Report

There was no legal counsel report.

VII. CIO Report

Ms. Fink referenced a question from the July 24 meeting regarding management fees. She said that the numbers are not confirmed. She said particularly with private equity and real estate, confirmation of their June valuations is needed. She said the numbers will definitely change and they are not final. She said for fiscal year 2013 the performance was up 11.1% net of all fees and expenses and the risk was about 8%. She said since adding the hedge funds 22 months ago, the fund is up 8.8% with 6% risk and that compares to 7.6% with 7.2% risk of a 60/40 portfolio. She said the asset allocation decisions that the board has made have really paid off.

She said that last year, the fund paid \$36,000,000 in management fees to fund managers which works out to about 0.5% of assets. She said that because it was a really good performance year there were also meaningful incentive fees. She said that both management and incentive fees add up to \$70,000,000 which is 0.9%.

Treasurer Raimondo asked Mr. Nesbitt to put the figures in perspective.

Mr. Nesbitt said that in relation to the performance it looks good. He said it is difficult to compare to other state pension systems due to fact that there is not a lot of transparency from other systems. He said the average expense ratio is somewhere between 0.40% and 0.50% not including incentive fees, which Rhode Island is one of few funds to disclose.

Ms. Reback asked where the custodians have physically placed the funds.

Mr. Nesbitt said that according to an analysis done in previous years approximately 90% of the assets are held physically in the U.S. and of the remaining 10% were held primarily in London. He

added that asking where the assets are domiciled is part of Cliffwater's operations due diligence with all hedge funds.

Treasurer Raimondo asked Mr. Nesbitt to have the analysis updated with the most current data. Ms. Fink reviewed the portfolio's performance for July. She said July was a very strong month in equities globally and the portfolio was up 2.7% for the month with 8% volatility. She said that compares with 2.9% for a bottom-up benchmark and for the 60/40 benchmark. She said the portfolio did underperform into the strong up market. She said the portfolio will tend to do better in weaker markets and not so well in strong markets and over time it should generate better returns. She reviewed the changes made to the benchmark. She said the benchmark has been refined by essentially creating two benchmarks. She said that one of the biggest changes is in private equity where the benchmark was changed to Venture Economics which is a more comparable benchmark. She said the return of a 60% global equities/40% core bond index has been added as an additional benchmark to evaluate the asset allocation of the plan.

Ms. Fink went on to review the August performance. She said it was a tough month in the markets. She said the portfolio was down 0.99% for the month in comparison to the bottom-up benchmark of -1.2% and the 60/40 portfolio of -1.5%. She said the hedge funds and the private equity allocations were big helps in the month. She said the hedge funds were down about 0.5%. She said since adding the hedge funds, the plan has outperformed the 60/40 plan by about 15% with about 15% less risk. Ms. Fink reminded the board about the efforts to align the OPEB trust with the core thinking of the SIC. She said that with approval from the OPEB board, the weighting was changed from 1/3 equity and 2/3 fixed income to 2/3 equity and 1/3 fixed income. She said this switch has really helped performance.

VIII. Treasurer Report

Treasurer Raimondo commended the efforts of the board and thanked them for their continued work.

There being no other business to come before the Board, on a motion by Ms. Reback and seconded by Mr. Fay the meeting adjourned at 11:19 a.m.

Respectfully submitted,



Gina M. Raimondo
General Treasurer