State Investment Commission
Monthly Meeting Minutes
Monday, January 27, 2014
9:00 a.m.
University of Rhode Island,
W. Alton Jones Campus—Sycamore Lodge

The Monthly Meeting of the State Investment Commission (SIC) was called to order at 9:06 a.m., Monday, January 27, 2014 in the Sycamore Lodge of the University of Rhode Island's W. Alton Jones Campus.

I. Roll Call of Members

The following members were present: Mr. J. Michael Costello, Mr. Thomas Fay, Mr. Robert Giudici, Ms. Paula McNamara, Mr. Thomas Mullaney, Ms. Marcia Reback, Mr. Frank Karpinski, and General Treasurer Gina Raimondo. Mr. Andrew Riley arrived at 9:24 a.m. Also in attendance: Mr. Gregory Balewicz and Mr. Daniel Farley of State Street Global Advisors (SSGA); Mr. John Burns, Ms. Judy Chambers, Mr. Alan Emkin, and Mr. David Glickman of Pension Consulting Alliance (PCA), general and real estate consultant; Mr. Thomas Lynch and Mr. Steve Nesbitt of Cliffwater, alternative investment consultant to the Commission; Ms. Susan Leach DeBlasio, of Adler Pollock & Sheehan P.C., legal counsel; Ms. Anne-Marie Fink, chief investment officer, members of the Treasurer's staff and Pete Spalding. Treasurer Raimondo called the meeting to order at 9:06 a.m. Mr. Karpinski left at 2:41 p.m.; Mr. Costello left at 3:06 p.m.

II. Approval of Minutes

On a motion by Ms. Reback and seconded by Mr. Giudici, it was unanimously
VOTED: to approve the draft of the minutes of the December 18, 2013 meeting of the State Investment Commission.
Mr. Riley was not present for this vote.

III. Review of ERSRI Actuarial Valuation

Mr. Karpinski reviewed the yearly ERSRI actuarial valuation for 2013. The valuation measures the liabilities, explains changes in the actuarial conditions and tracks changes over time.
He reviewed the funded ratios. He noted that due to actuarial smoothing and amortization of shortfalls, the actuarial value of assets dipped in fiscal year 2013.
He discussed a graph showing the actuary projections from the 2012 valuation compared to the actual 2013 valuation. The positive sources of impact were that the investments outperformed the 7.5% assumption and the liabilities grew at a slower pace than expected.
The negative impacts were lower contributions. He explained how contributions are collected. The actuary predicts contributions that are based on growth rates and payrolls. When lower than expected contributions are received, the following year's contribution rate must be increased to compensate for the prior year. The projected sources of funds are employee contributions, taxpayer

or employer contributions and the portfolio. If there are losses in any given year, the employer must make up the difference.

He noted some actuarial changes. Investments had a 6.7% return using a five-year smoothing. That generated cost of living adjustments (COLAs) for 56 municipal units. These municipal units have reached the 80% funding level. State employees, teachers, state police, and judges have yet to reach the 80% funding levels so no COLAs have been reinstated. He reviewed the actuarial asset values. He said they show the difference between compounded returns of 7.24% for the last 10 years and the simple average return of 8%.

He noted that the number of current state employees are almost a one-to-one match to the number of retirees. The actuaries foresee a reasonable projected increase in benefit payments.

He added that funding ratios are improving.

IV. Overview of Markets and Recent Performance

Mr. Farley reviewed the broad capital markets and economic outlook. SSGA believes global recovery is happening, although occurring differently around the world. The US is improving. The Eurozone is going from bad to weak. In Asia, there are a lot of good things in Japan that are creating recovery, but he also sees China causing some negative ripple effects in the markets.

He reviewed SSGA's perspective on global growth. Their view for next year is 3.6% global GDP growth, which is in line with long-term historical averages. SSGA forecasts that US GDP will come in at about 1.7% this past year and next year jump up to 2.8%. In the Eurozone, they project GDP growth to come in modestly negative for 2013, jumping up to a modestly positive number in 2014. Japan is projected to be relatively flat on a year-over-year perspective, but they see a little bit of a pick-up from an emerging markets perspective.

In Europe they foresee the banking system continuing to be a big issue, but expect improvement. In Japan they see that Abenomics is keeping the yen lower, allowing Japan to stay competitive in exporting, seeing improvements in hiring and ultimately wage increases. In emerging markets SSGA foresees a more controlled slow-down but not a significant one.

He reviewed SSGA's Market Regime Indicator and how it measures investor sentiment. This indicator forecasts what kind of market environment we will be in in the next 6-12 months. They haven't seen a major spark in risk with their measures. They see a reasonably good economic backdrop and accommodative monetary policy.

He reviewed the outlook for fixed income rates. Their perspective is that rates will continue to move up across the developed markets and particularly in the US. Their concern is a big spike in rates because people want to get out of rising rates in the future. This has the potential for rates to spike much faster and would have a very big ripple effect across multiple markets.

He reviewed the outlook for the equity markets. Their view is that US equities are not cheap anymore but are not overvalued either. Looking at other parts of the world, valuations in Europe are much cheaper. Accommodative policy in Japan continues to be a very positive thing there. He described emerging markets as a wildcard. SSGA doesn't think now is the time to get back in to emerging markets from an overweight perspective.

He reviewed SSGA's active positions in their portfolios right now. They continue to be very positive in equities, about 8% overweight stocks across the portfolios, with a modest overweight to US. Their biggest positions are in European and Asia Pacific equities. They are underweight in emerging markets and fixed income. They have a bit of an overweight to long credit as they are taking advantage of the spreads.

He discussed their forecast looking across multiple time horizons. Looking forward, they see a market where the focus on diversification and returns will be harder to come by.
The board asked questions.

V. Chief Investment Officer Report

Ms. Fink said December was a good month and the portfolio was up 0.99%. Fiscal year to date, the portfolio was up 9.7% and 14.1% for the calendar year. Risk was at 7.2%. The 60/40 plan generated 0.8% in December, 9.5% FYTD and 12.3% for the calendar year, with a risk of 8.3%. The portfolio's performance did lag that of the bottom-up benchmark, mostly because the absolute return hedge funds in the portfolio tend to have less market sensitivity than the benchmark. The other place where there seems to be a bit of a mismatch is in real estate and that is just a timing issue for how the returns come in.
She said the strong performance was driven by developed equity markets. The portfolio's underweight in bonds mitigated the impact of rising rates due to Fed tapering.
The equity hedge funds performed well in December despite having less market sensitivity.
In January, the equity markets have come down and bonds have stabilized. Dispersion between stocks has continued so the hedge funds have done very well.

VI. Asset Allocation Review

Mr. Emkin noted that since the last time this review was done in 2012, the capital markets have changed. The biggest single change is that the equity markets have had an extraordinary rally. They assume the return on stocks will be plus or minus 8%. US stocks last year were up 32%; simplistically that's 4 years' worth of returns in one year.
He noted this would be a mid-course review, not a full asset/liability study. This review just looks at the investment component and not liabilities. He noted it's important to keep in mind that the plans are still underfunded, on average. The plans are mature, meaning that the number of retirees is growing much more rapidly than active members. This demographic means less contributions, putting increased burden on employer contributions and the investment portfolio to generate rates of return. This must be managed on both the liability and the asset sides as the plan's planning horizon changes. The ultimate goal of the plan is to pay benefits. Having major losses has a disproportionate negative impact on the portfolio because there is not enough money coming in to overcome the losses over time.
He noted that capital markets tend to overreact on the extremes. The cost of losing lots of money on the downside is disproportionate to making money on the upside.
He explained how actual geometric return is always less than the arithmetic return because of the volatility penalty. The more volatility the greater that penalty. He reviewed an example of the impact of volatility and the impact when assets go up and down together. This example demonstrated the need to be diversified and to manage the asset allocation.
He explained the optimization model used by PCA to generate potential allocations for the asset allocation review. He briefly reviewed the role of each asset class and its risk. He noted that the goal of the study is to identify how each asset reacts in different economic conditions and the correlation between them. He discussed the impact of the recent economic instability on various portfolio combinations. He explained how they input correlation into the model. The goal is to combine assets that are not highly correlated. He noted asset correlations can change and provide a

challenge as they are not stable over time. PCA revisits these correlations and makes changes based on the way the market is being perceived over time.

The model generated portfolios that provide the best return per unit of risk at different risk levels, which is called the “efficient frontier”. Performance of portfolios and asset classes is measured by using the Sharpe ratio to see if the risk taken is paying off in returns.

He reviewed the resulting portfolios that the optimizer generated when the assumptions and constraints were entered. He compared these outputs to the current portfolio and the 60/40 plan. He said the current portfolio has slightly more risk. The current portfolio is pretty close to the efficient frontier. The fact that the portfolio is slightly off the efficient frontier is normal.

Mr. Nesbitt noted that more alternative investments would get the portfolio even closer to the “efficient frontier”.

Mr. Emkin presented a graph with a 60/40 allocation. He noted the volatility is 93% from stock and only 7% from bonds. The goal of diversification is to reduce that concentration of risk. The difficulty is that with the exception of private equity, every other asset class has a lower expected rate of return than public equity. Diversification will improve the relationship between return and risk.

He presented another graph showing the current portfolio using the same methodology. He estimates that between 80% and 85% of the current portfolio’s volatility is driven by the equity market because equity market risk exists across different asset classes. He compared this to a portfolio generated by the optimizer with a higher Sharpe ratio. He noted that effectively, the allocation to alternative assets gets maxed out because they have the highest Sharpe ratios. Adding alternatives to the portfolio makes for more diversified sources of risk. If the portfolio gets less volatility with similar rates of return, over the long term, it will compound to a greater level.

Mr. Emkin discussed how the portfolio needs to have assets available to pay benefits. The key is to align cash flows out of the pension funds with the contributions and income of the investment portfolio to meet liabilities without having to sell assets at the wrong point in time. Because of the demographics and financial conditions of the plan, much more thought has to be given to liquidity and loss aversion.

He reviewed a mathematical example of the impact of volatility comparing two portfolios with the same rate of return. One having more volatility than the other. He noted that with a mature plan, at the end of the sample period the more volatile portfolio has less money than the other. Managing and reducing volatility increases the likelihood of having the assets to pay benefits when they come due. The cost of taking too much risk is the potential for not having the ability to meet the obligations.

Ms. Fink noted that the example illustrates how the impact of volatility is more painful with a more mature portfolio.

Mr. Emkin said the challenge is how to generate the best risk-adjusted return. Given the current assumptions, the only way to improve the risk-return relationship is to expand away from the 60/40 portfolio by moving to assets with better Sharpe ratios and better risk-adjusted rates of return. He said the board may consider expanding or changing some of the hedge fund portfolios at the margins. He said he foresees a more challenging environment to generate the 7.5% rate of return.

Ms. Fink added that the work of PCA is comforting to her given how close the current portfolio is to the efficient frontier. She said that no vote would be taken regarding asset allocation as there was no vote scheduled on the agenda. However, the board could discuss this further at a future meeting.

The board asked questions.

VII. Investment Policy Statement Review

Ms. Fink reviewed the second part of the Investment Policy draft. This part of the Investment Policy is designed to address the roles and responsibilities of the various parties that work on the portfolio.

Mr. Costello expressed concern over the 7.5% expected rate of return stated in the Investment Policy draft. He referred to the previous presentations by both State Street and PCA regarding future market environment and how it would be difficult to achieve that return.

Mr. Riley suggested that the policy should include language clarifying that the 7.5% is the targeted return which is given to the SIC by another governing body.

The board further discussed the Investment Policy.

Ms. Fink asked the board for a vote on part one of the Investment Policy.

Ms. Reback expressed concern that she believed the policy emphasized risk over return. She said that she would abstain from a vote pertaining to the first part of the Investment Policy.

Treasurer Raimondo suggested to further discuss the Policy and to postpone a vote for both parts until the next meeting. She asked Ms. Fink to incorporate the feedback given by the board and to present the Policy at the next meeting.

VIII. Fiduciary Training

Mr. Mark Dingley, Treasury Legal Counsel, explained the fiduciary responsibility and liabilities. He said the SIC acts in a fiduciary role and is defined as a fiduciary. The number one rule for a fiduciary is to follow the plan documents. For the SIC those are the statutes and any adopted policy. He identified the legal sources of fiduciary requirements as ERISA, the Internal Revenue Code, State and Local Statutes and ordinances, common law, and plan documents such as Investment Policies. These should be the blueprint for decision-making.

He explained the division of responsibility between the employer and the fiduciary. The fiduciary responsibilities are to act in accordance with the Exclusive Benefit Rule and Prudent Person Standard, to follow the plan documents, to diversify investments, and to monitor service providers.

He reviewed the rules that apply under RIGL 35-10-6, known as the Exclusive Benefit Rule. The rules requires members to act solely in the interest of plan participants and beneficiaries, to act with the exclusive purpose of providing benefits to participants, to pay reasonable administrative expenses, and to follow the no-self-dealing or conflict-of-interest rule.

The prudent person standard adopted by the State is an experienced prudent person standard. It is the highest fiduciary standard out there. He reviewed the doctrine of procedural prudence. The duties of the SIC are to investigate, make informed decisions, maintain accurate records, obtain expert assistance, monitor the investments, and follow the plan documents.

The purpose of diversification is to mitigate losses and protect participants from fraud. He reviewed the factors to consider in regards to diversification.

He reviewed the duty to secure expert assistance and monitor providers.

He discussed the liabilities of fiduciaries as read in section 9-1-31.1 of the Rhode Island General Law. He reviewed the limitation of liability. Generally, the board has protection from civil liability.

Mr. Giudici asked how the fiduciary liability applies to custodians and fund manager contracts.

Mr. Dingley said that it is a different type of fiduciary responsibility. When the board is successful in getting managers to acknowledge a fiduciary status, it's one that they will adhere to the investment directives given to them. Their responsibility is to advise the board. The ultimate fiduciary responsibility rests with the board members.

He went on to talk about the defined contribution plan and how it adheres to the ERISA guidelines.

IX. Survey of Portfolio by Asset Class

Ms. Fink compared three snapshots of the portfolio: the policy allocation, the tactical allocation and the actual allocation. The tactical allocation differs from the policy allocation due to the nature of some of the asset classes and the time required to deploy investments in these classes. The actual allocation differs from the tactical allocation due to impacts of market moves.

Mr. Burns briefly reviewed the role of each asset class and the type of risk associated with each asset class depending on how the portfolio is constructed. He went on to review the public equity portion of the portfolio. Global equities are the largest investment. It has a high expected return with an expected volatility of about 18%. Historically, that risk has paid off. He described the equity portfolio as a beta portfolio, as it will move in line with the overall equity markets. The portfolio is well-diversified by country, economic sector and industry. He reviewed price/earnings ratio statistics of the current public equity market compared to long-time averages, as an indication of valuations.

Mr. Lynch reviewed the fund's private equity portfolio. The primary risk exposure of private equity is growth. It has a high expected return with a volatility of about 20%. Liquidity is low in this asset class as the investments are in partnerships with an average 10-year life. He described the investment strategy for private equity. The key differentiation from public equity is that this is where the portfolio can get alpha return as managers are active and have tools to add value. He briefly summarized the portfolio since inception. He described the portfolio as well diversified by manager, fund and industry. He reviewed the performance of the portfolio. Since inception, the portfolio has outperformed the benchmark by 2.35%. Relative to public equities, the portfolio has also outperformed the Russell 3000 Index by 6.76% since inception. He described the typical measurements of performance.

Mr. Nesbitt reviewed the fund's hedged equity portfolio. This group of hedge fund strategies is designed to produce equity-like returns with approximately half the risk. He described the investment strategy of hedged equity. The role of this portion of the portfolio is to lower the risk of the equity portfolio. He reviewed what is in the portfolio. This allocation has lowered risk with a standard deviation of 3.68% since inception. He discussed the performance of the portfolio. Since inception and through December of 2013, the portfolio return is 10.9% with 3.68% risk.

Mr. Glickman reviewed the fund's real estate portfolio. The primary role of the real estate portfolio is to provide income and a secondary role is to provide growth opportunities over a long period of time. The growth in real estate values will be fairly well correlated to the overall growth of the economy. He said PCA feels positive about the real estate market as uncertainty in the economy has begun to melt away. He briefly reviewed the diversification of the real estate portfolio and said it generally lines up closely to what the reported benchmark should be. He went on to discuss the performance of the real estate portfolio.

Ms. Chambers reviewed the fund's infrastructure portfolio. She noted that the investment in IFM that was approved by the SIC in 2013 has yet to be drawn down. She said there is no guarantee when the fund will call Rhode Island's funds but she is hoping it will be sometime this year. She discussed the current marketplace. She will continue to work with staff and come back to the board with additional opportunities when appropriate.

Mr. Nesbitt reviewed the absolute return hedge fund portfolio. The design of these funds is to mitigate risk and do well when the market goes down. He reviewed the investment strategy for the portfolio. The portfolio is diversified across strategies. The beta for the absolute return hedge funds is 0.06% with volatility of 2.38%. He reviewed the performance of the portfolio. This is a very efficient asset class with a Sharpe ratio of 2.31%.

Mr. Burns reviewed the rate-insulated credit portfolio. The addition of this asset class was part of the strategy to reduce interest rate risk in the portfolio. He discussed the spread on bank loans, a valuation measure. He noted that there are allocations to two managers with two different strategies in the portfolio and they are well diversified across sectors.

Mr. Burns went on to review the GILBs portion of the portfolio. The primary risk in this portfolio is inflation. The benchmark was recently changed to intermediate benchmark so they take even less duration risk.

Ms. Fink noted that this is the part of the portfolio that did not work last year because inflation was lower than expected and interest rates backed up. Usually when rates back up it's because there is inflation and the GILBs are designed to protect in that environment.

X. Recommendation to Reduce Beta Exposure in Hedged Equity Allocation

Ms. Fink noted that last year was a great year for equities but returns can be expected to be lower going forward. She identified the possibility of reducing the beta exposure in the portfolio. She recommended redeeming the Third Point investment and putting the money back to work within the hedge fund allocation but with lower beta exposure. The Third Point investment is about $70 million. She recommended putting $20 million of that into Samlyn. Rhode Island already has an investment with Samlyn and they have performed very well. She added that Samlyn has two share classes. One is a traditional fee structure with a one-year commitment and the other has lower fees and a three-year commitment. She recommended putting the $20 million in the share class with the three-year commitment and lower fees. Cliffwater would be enlisted to bring a recommendation to invest the rest of the money.

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

VOTED: to redeem the investment in Third Point.

Additionally, a motion was made by Mr. Giudici and seconded by Ms. Reback, and it was unanimously

VOTED: to invest $20 million into Samlyn's share class with the longer lockup and lower fee structure.

XI. Secondary Sale Update

A motion was made by Ms. Reback and seconded by Mr. Fay to convene into executive session pursuant to Rhode Island General Law §42-46-5 (a) (7) as the discussion may relate to the investment of public funds, the premature disclosure of which may adversely affect the public interest. A roll call vote was taken to enter into executive session and the following members were present and voted Yea: Mr. Thomas Fay, Mr. Robert Giudici, Ms. Paula McNamara, Mr. Thomas Mullaney, Ms. Marcia Reback, Mr. Andrew Riley, and General Treasurer Gina Raimondo. Mr. Costello was not present.

It was then unanimously

VOTED: To convene into executive session pursuant to Rhode Island General Law §42-46-5 (a) (7) as the discussion may relate to the investment of public funds, the premature disclosure of which may adversely affect the public interest.

A motion was then made by Mr. Mullaney and seconded by Mr. Riley, to exit executive session pursuant to Rhode Island General Law §42-46-5 (a) (7). A roll call vote was taken, and the following members were present and voted Yea: Mr. Thomas Fay, Mr. Robert Giudici, Ms. Paula McNamara, Mr. Thomas Mullaney, Ms. Marcia Reback, Mr. Andrew Riley, and General Treasurer Gina Raimondo. Mr. Costello was not present.
It was then unanimously
VOTED: To exit executive session and return to open session.

It was reported to the public that there were votes taken during the executive session.
It was unanimously voted to authorize staff to take action to sell the USC interest in Wellspring Capital Partners IV. Mr. Costello was not present for this vote. And it was unanimously voted to seal the minutes.

XII. Legal Counsel Report

There was no legal counsel report.

XIII. 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 Ms. McNamara the meeting adjourned at 3:25 p.m.

Respectfully submitted,

Gina Raimondo

Gina M. Raimondo
General Treasurer