State Investment Commission
Monthly Meeting Minutes
Wednesday, February 26, 2014
9:00 a.m.
Room 205, State House

The Monthly Meeting of the State Investment Commission (SIC) was called to order at 9:04 a.m., Wednesday, February 26, 2014 in Room 205, State House.

I. Roll Call of Members

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

Also in attendance: Mr. Larry Brown and Mr. Darren Lopes of TIAA-CREF, defined contribution plan administrator; Mr. Thomas Lynch of Cliffwater, alternative investment consultant to the Commission; Ms. Monica Chase and Mr. Loren Schlachet of The Riverside Company; Mr. John Burns and Mr. Alan Emkin of Pension Consulting Alliance (PCA), general consultant; Ms. Sally Dowling of Adler Pollock & Sheehan P.C., legal counsel; Mr. Kevin Sullivan and Mr. Mark Sullivan of Bank of New York Mellon, custodian to the pension plan; Mr. Seth Magaziner, candidate for treasurer; Ms. Anne-Marie Fink, chief investment officer, and members of the Treasurer's staff. Treasurer Raimondo called the meeting to order at 9:04 a.m.

Mr. Thomas Fay and Mr. Andrew Reilly were absent.

II. Approval of Minutes

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

VOTED: to approve the draft of the minutes of the January 27, 2014 meeting of the State Investment Commission.

III. Defined Contribution Plan—Quarterly Update

Mr. Lopes provided an overview of the State's D/C plan at year end 2013. As of December 31, 2013 the plan had a total of $196 million in assets. The bulk of the assets remain in the target-date funds. Effective March 12, 2014 the social choice equity fund will be added to the lineup as an option for participants. A communication has gone out to participants to notify them of the addition. He also provided an update on TIAA-CREF's continuing outreach efforts, saying the number of meetings with participants increased throughout 2013.

Mr. Brown reviewed the performance of the plan. He noted the stable value current rate as of the first of February has increased to 2% from 1.75%. He reviewed how each class ranks against its peers. The Vanguard total bond market index had negative returns last quarter but it has since topped the underlying benchmark. The only portion of the fixed income market that posted positive returns last year was high yield. The plan did offer participants an opportunity to capture large returns in the equity markets, ranging from 32% for the large cap S&P 500 to 37.7% for small caps. All these funds are in the top half of their respective peer groups.

The international equity index posted a 29.9% return and was in the top quartile. Real estate investment selections had a return of 9.65%. Vanguard target-date fund returns have ranged from 5.8% in the retirement income trust to 24% in the target date funds with longer horizons. The average peer group rankings for the Vanguard funds are in 28th percentile. He said all the funds have performed as expected.

IV. Private Equity Recommendation—Riverside Micro Cap III

Mr. Lynch introduced The Riverside Company. He reminded the board that in 2013 an investment in another Riverside Company fund was approved. He added that the current strategy for ERSRI private equity allocation is to increase the exposure to smaller company buyouts, which offer more attractive opportunities. Today there is a lot of competition for larger company buyouts so he believes targeting smaller companies should have a competitive advantage.

Mr. Schlachet gave a brief review of Riverside Company and its Micro-Cap Fund III. This fund invests in lower middle market private companies around the world. Their consistent approach has proven effective as measured on returns. The fund seeks to buy the very best companies in North America with less than $5 million Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA).

He reviewed the team and touted their expertise and experience. They have had 9 years of experience in a micro-cap fund and have acquired 75 companies during that time. They see no shortages of small companies with robust prospects.

He added that their team is split between investors and operators. They bring the benefit of Riverside's global private equity platform to the lowest end of the middle market. One of the unique aspects of this fund is that they are a Small Business Investment Company (SBIC). On each fund they are able to borrow up to $150M from the Small Business Administration (SBA) at a cost of 4%.

Mr. Giudici asked if they are actively involved in the running of their portfolio companies.

Mr. Schlachet said they buy the controlling equity stake in an underlying company as well as offering mezzanine debt. Once they make an investment, they do not bring in their own management team. The companies have their own management teams, board of directors, and balance sheets. The Riverside team is most involved in strategy and overall efficiency.

Mr. Giudici asked where the cash flow comes from to pay back the debt.

Mr. Schlachet explained that when they buy a company, the first three turns of the capital structure will be financed with bank debt. The next turn and a half will be Riverside's mezzanine debt. On the mezzanine piece, they charge 18% with 12% being current pay and 6% payment in kind. The 12% is paid on a quarterly basis to the fund. This interest income more than satisfies the interest expense from the SBA loan.

Mr. Giudici asked how many of the companies they have invested in that have failed.

Mr. Schlachet said they have done 36 platforms to date and have lost money on only two platforms. He would estimate over the long term the loss ratio would be between 10-12%.

Mr. Schlachet then gave an overview of the investment strategy. Riverside holds companies for five to seven years. The companies they acquire are growing at an average 27% per year leading up to acquisition. They look for companies that have recurring revenue and do not have large customer concentrations.

He reviewed the composition of the portfolio. Their growth-oriented investment strategy leads them into sectors like software, branded consumer products, and healthcare. They focus on the ability of a company to grow organically so they seek sectors where there are still a lot of growth opportunities.

He said they focus on add-on acquisitions. They do roughly 1.4 times add-ons for every platform. It has been a very successful strategy for them.

Talking about their performance, he said they have had top quartile performance across 36 platforms. They have had two formal funds to date, RMCF I and RMCF II. RMCF I is a top quartile performer with marks of 1.9 times and 13% net return as of year-end 2013. They still have about 13 companies left in the first fund that still have a lot of value to be created. Ultimately, they see the entire fund return ending up at about 2.3X net of fees.

The board asked questions.

The representatives from The Riverside Company left the room.

Mr. Lynch noted that Cliffwater recommends a $20 million investment into RMCF III.

Ms. Fink noted that the SBIC space enables going down in size, where there is less competition. In a time when private equity is very competitive, Riverside is targeting a niche of the market that is less competitive, which means higher returns.

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

VOTED: to invest $20 million into Riverside Micro Cap Fund III.

Ms. Reback voted nay.

V. Hedge Fund Review—Calendar Year 2013

Mr. Lynch reviewed the performance of the hedge fund portfolio from inception through January 2014. The absolute return hedge funds have $511 million of invested capital across 9 hedge funds. With an annualized return of 5.75%, the absolute return hedge funds have risk comparable to bonds with a higher rate of return. The global equity hedge funds have $635 million invested capital across 9 hedge funds. They have a 10.5% return with volatility below 4%, which is a two thirds reduction in risk relative to the equity market. Both portfolios have a combined 8.33% return and have produced these returns with very attractive levels of risk. Also, both portfolios have outperformed their relative benchmarks.

Mr. Lynch then gave an overview of the components of return: alpha and beta. Beta is a measure of market exposure. Alpha is the return that the manager produces above the market return. The goal is to try to manage the beta and get a lot of alpha. He pointed out that there has substantial alpha produced in both the global equity and the real return portfolios. Likewise, the beta for the equity hedge fund index has only been 0.24, basically ¾ less beta than the equity index. The beta for the real return portfolio has been 0.09 so less than 10% of the beta of the equity index. The alpha of global equity hedge funds has been 7.3% annualized. The real return portfolio's alpha has been 4.41%. The alpha in their respective benchmarks has been substantially less than that in the portfolio. He reviewed the alpha by manager. The alpha has been positive for all the managers except two, Indus Asia and Winton Futures. Indus Asia invests in Asia markets, was a difficult place to perform last year. Winton Futures, which is a commodity trading advisor (CTA) that uses a quantitative momentum strategy, is also in a space that was challenging last year. It is expected that not all strategies or geographies will perform in all environments.

The board asked questions.

VI. Asset Allocation Review

Mr. Emkin gave a follow-up to the discussion at the previous meeting regarding asset allocation. He reviewed the findings of the process. He said in a well-diversified portfolio where most of the risk is equity risk, adding return becomes challenging because any amount of return would add significant amounts of risk. He noted that there is no compelling reason to change the current policy portfolio and PCA would encourage the board to stay the course on the current track.

He said PCA had few minor recommendations. In the near term, they recommend focusing on fully implementing the current policy, particularly filling out the real estate and infrastructure allocations. They would like to see more money being allocated to assets that are less correlated to the equity market and to remain mindful of diversifying by vintage year.

VII. Investment Policy Statement Review

Ms. Fink talked about some of the changes in the Investment Policy Draft. She said the policy now states more explicitly that the 7.5% is an actuarial rate of return is determined by The Retirement Board. Also, throughout the document the goal of achieving returns is emphasized as much as the need to manage risk.

Ms. Reback pointed out that the corporate governance piece should clarify which "Board" is being referenced.

Ms. Fink agreed and said the change would be made.

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

VOTED: to adopt parts 1 and 2 of the Investment Policy draft with the clarification of "corporate boards" in the corporate governance section.

VIII. Legal Counsel Report

There was no legal counsel report.

IX. CIO Report

Ms. Fink reviewed January's performance, stating it was a tough month due to concerns over emerging markets growth and fourth quarter earnings were lacking. In this environment the portfolio was down 1.7%, which compared favorably to the 60/40 benchmark which fell 1.8%. Asset allocation is working, particularly the hedge funds, which helped protect the portfolio in January. Fiscal-year-to-date the portfolio is up 7.9% compared to the 60/40 benchmark, which is up 7.5%. The portfolio had 7.5% risk with a return of about 8%. She reviewed the performance of each asset class for the month.

Ms. Fink gave an update on the Waterton investment. She said Waterton has raised more than $200 million outside of the investment by Rhode Island. Consistent with what was previously voted upon by the SIC staff will invest about $20 million of the approved $35 million to work in the fund. If Waterton manages to raise more money, the rest of the money will be put to work in subsequent transactions.

Ms. Fink notified the board there will be an RFP issued jointly with RIHEAA seeking a consultant to assist in the evaluation of the 529 college plan.

Ms. Fink briefly commented on February's markets. She said February has been an almost complete reversal of January with equity markets up more than 4% and treasury yields up a bit to 2.75% on the 10-year. She added that as of February 21st, the defined benefit portfolio was back above $8 billion.

X. Treasurer Report

Treasurer Raimondo thanked the consultants for their work.

She then gave an update on the recent mediated pension settlement. She distributed a press release from the governor's office in conjunction with her office outlining some of the changes. She noted the settlement would not change the work of the board and that it only has a negligible impact on the unfunded liability. All the key structural changes will stay in place. She also noted that the settlement is not yet finalized as the union membership has to vote on it, and then it must go before the general assembly.

Treasurer Raimondo commended 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. Mullaney the meeting adjourned at 10:41 a.m.

Respectfully submitted,

Gina M. Raimondo
General Treasurer