State Investment Commission

Monthly Meeting Minutes
Wednesday, May 28, 2014
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, May 28, 2014 in Room 205, State House.

I. Roll Call of Members

The following members were present: Mr. Thomas Fay, Mr. Robert Giudici, Ms. Paula McNamara, Mr. Thomas Mullaney, Ms. Marcia Reback, Mr. Andrew Reilly, Mr. Frank Karpinski, and General Treasurer Gina Raimondo.
Also in attendance: Mr. Larry Brown of TIAA-CREF, defined contribution plan administrator; Ms. Ellen Savary of Fidelity Investments, 457 plan provider; Mr. Thomas Lynch and Mr. Steve Nesbitt of Cliffwater, alternative investment consultant to the Commission; Mr. John Burns and Mr. David Glickman of Pension Consulting Alliance (PCA), general consultant;
Mr. Ward Fitzgerald of Exeter Property Group; Mr. Matthew Novak and Mr. Aaron Snegg of Industry Capital; Mr. Joe Grogan and Ms. Rakhi Kumar of State Street Global Advisors (SSGA); Ms. Sally Dowling of Adler Pollock & Sheehan P.C., legal counsel; Mr. Mark Sullivan of Bank New York Mellon, custodian bank to the fund; Ms. Faith LaSalle, Esq., Chairperson of the Rhode Island Higher Education Assistance Authority (RIHEAA) Board of Directors; Ms. Anne-Marie Fink, chief investment officer, and members of the Treasurer's staff.
Treasurer Raimondo called the meeting to order at 9:03 a.m.
Mr. J. Michael Costello was absent. Ms. McNamara left at 11:23 a.m.

II. Approval of Minutes

On a motion by Mr. Giudici and seconded by Mr. Fay, it was unanimously
VOTED: to approve the draft of the minutes of the April 23, 2014 meeting of the State Investment Commission.

III. Defined Contribution Plan—Quarterly Update

Mr. Brown reviewed the plan and said it holds nearly $244 million at the end of April. 92% of the plan's assets are in the Vanguard target-date funds. He mentioned that consultations with participants for 2014are on pace to eclipse the number of sessions held last year.
He went on to review the returns of the investment lineup. As of March 31, the returns were all in line with their respective benchmarks. He reviewed the rankings of the underlying funds versus the relevant peer groups.
Mr. Brown began an in-depth analysis on the target-date fund universe towards the end of the presentation. He noted the Vanguard funds rankings are very competitive with their peer groups. He compared Vanguard to the rest of the target-date market, specifically comparing the assets used and progression of the allocations. He added that Vanguard has five underlying mutual funds where some others in the market have 20+. Vanguard funds' risk and return profiles are top tier.

Mr. Brown noted that the SEC currently has a proposal to mandate that marketing materials forglide-path funds show not only asset allocation but also some measure of risk. This mandate has not been approved yet; it's still out for public comment.
He compared the equity exposure of the Vanguard funds and the other funds in the market. He noted that Vanguard doesn't have the most equity exposure or the least; it's right in the middle. He added that the Vanguard funds are getting similar returns with standard deviations that are line with the rest of the glide-path universe.

IV. Fidelity 457 Share Class Recommendations

Ms. Fink said that funds within the 457 plan with Fidelity have reached size thresholds such that they can be switched into cheaper institutional share classes.
Ms. Savary explained that Fidelity is proposing to switch into lower-fee share classes for five different funds within the line-up. She reviewed each of the five current share classes and the share class Fidelity recommends switching into.
The recommendations are as follow: switching Fidelity Contra Fund to the Fidelity Contra Fund Class K, Fidelity Low Price Stock Fund to the Fidelity Low Price Stock Fund Class K, The Harbor International Fund Investor Class to The Harbor International Fund Institutional Class, the Invesco Diversified Dividend Fund Investor Class to the Invesco Diversified Dividend Fund R5 Class, the PIMCO Total Return Fund Administrative to the PIMCO Total Return Class Institutional Fund.
The move would lower fees by about 0.10% annually and these five funds make up about 45% of the plan assets. It's about a $50,000 reduction overall.

On a motion by Ms. Reback and seconded by Mr. Reilly, it was unanimously
VOTED: to switch to the new lower-fee share classes.

V. CollegeBound*fund* Extension Recommendation

Ms. Fink noted that the contract with Alliance Bernstein, record keeper and administrator of CollegeBound*fund*, is up at the end of June 2015. If the board does not intend to renew the contract for five additional years, Alliance Bernstein must be notified by end of June 2014.
She added that during this administration, a lot of changes have been made to the plan and its offerings. Although many of these changes were voted on by the SIC in October, they were not implemented until the end of March due to time required to make changes to prospectuses and other legal documents. The changes are just starting to take hold among investors.
Additionally, an RFP was just issued to hire an advisor to oversee the program's investment line-up. Given the newness and innovativeness of the investment changes and the time required to evaluate and hire a consultant to advise on the program's investment options, she believes some additional time on the contract would be a beneficial. She proposed a one-year extension on the contract to allow the new investment options to really take hold and to make sure the program is getting the best results for the State. She noted that RIHEAA also has to make a decision on the contract extension and they have voted to approve it.
The board discussed the recommendation.

On a motion by Mr. Mullaney and seconded by Ms. Reback, it was unanimously
VOTED: to approve a one-year extension of the contract with Alliance Bernstein.

VI. Alternatives Consultant Review

Mr. Nesbitt gave an overview of Cliffwater. He started by reviewing the organization. Cliffwater has 36 clients, of which 31 receive advice on hedge funds. Over its ten-year history, Cliffwater has established themselves as a leader in alternatives. He reviewed some of the firm's clients. The coverage spans hedge funds, private equity, real assets and real estate.

Next, he reviewed their organizational structure. He described the investment process and how the team conducts operations due diligence. He said each functional group will vote on funds when their due diligence has been done. If they approve it, a fund will then go on to Cliffwater's investment committee comprised of senior personnel who hold a final vote on whether Cliffwater can recommend a fund.

Some of the firm's defining characteristics are their uniform process and collective decision-making. The team prides themselves on 100% transparency. Everything they see is available to clients subject to non-disclosure agreements. They consider themselves a client-driven organization.

Mr. Lynch briefly noted that they do yearly due diligence on funds and monthly monitoring meetings with the managers. Clients are given regular risk reports along with the performance reports for the managers in their portfolios.

Next, Mr. Lynch reviewed the services provided by the private equity group. The recommendation process is similar to that of the hedge funds. In addition, the team has a quarterly monitoring process.

Mr. Nesbitt gave an overview of the activity in the hedge fund portfolio. Hedge fund results are in line with expectations. Return was 7.56% at a risk level of 3.12%. Since inception the hedge fund portfolio has outperformed the HFRI fund of funds index by about 3% per year net of fees with a lower level of risk. From an allocation point of view, they view hedge funds as a substitute for fixed income with a comparable level of risk but higher level of return. They view private equity as delivering something akin to the risk of public equities but higher level of return.

Mr. Lynch reviewed the progress in the private equity portfolio. The goal is to achieve long-term returns equal to public equity returns plus 3%. To maintain the strategic allocation of 8%, new commitments must be made continually because private equity firms return capital and don't automatically reinvest it. He reviewed the activity of the private equity portfolio over the past three years. The portfolio has had approximately $300 million in commitments with 14 partnerships. In terms of structuring, Cliffwater would like to move some of the allocation into more attractive areas and diversify portfolio. They would like to limit the allocation to more competitive areas.

He reviewed the performance of the private equity portfolio since Cliffwater came on as the consultant. He cautioned that it is too early to talk about performance because the average fund Cliffwater recommended has been in the portfolio about 1.3 years. Cumulatively, the portfolio has produced a return of 10.7% since inception. Overall, the portfolio has an internal rate of return of approximately 14% since inception. He added that the private equity portfolio continues to outperform equities.

The board asked questions.

Cliffwater left the room.

Ms. Fink said as the third anniversary with Cliffwater approaches, it would is a good time to review the existing partnership and whether to continue it. She noted that the current contract does not have an expiration date; in the event that the board wanted to end the contract, it would only require 30 days' notice to Cliffwater. She mentioned that the Massachusetts Pension Reserves Investment Management Board recently ended its hedge-fund advisory relationship with Cliffwater, hiring a different firm with expertise in running separately managed accounts. Given the complex implementation and staffing requirements for separate accounts, she suggested further research and observation before exploring separate accounts. Then she explained her review process of the consultant landscape. She surveyed the universe and did further research on two other consultants, who stood out as particularly well regarded. She reviewed how these firms compared to Cliffwater. She concluded that, while the other consultants had some relative advantages and disadvantages, these differences were not significant enough to warrant a change to a more expensive consultant, which both of these would be. Based on a combination of the fees, the continuity of approach, and the strong work from Cliffwater, she recommended the SIC continue its contract engagement with Cliffwater. She stated that staff would continue to monitor the landscape and look for best practices. She also noted that there are still several things Cliffwater is working on improving in regards to reporting.

VII. Real Estate Recommendations—Exeter Industrial Value Fund III L.P. and IC Berkeley Partners III L.P.

Mr. Glickman said his goal continues to be to reach the target real estate allocation. The commitments made during the last twelve months are beginning to be drawn down and invested. PCA expects more commitments to be made through the remainder of the year and into the next calendar year in order to reach the target amount and maintain vintage year diversity.
Mr. Glickman gave a brief review of the real estate market. He said the asset values and the leasing markets continue to firm up, particularly in industrial which has lagged other real estate types in the recovery. PCA believes this is an appropriate time to be looking at industrial real estate.

Mr. Fitzgerald introduced the Exeter Industrial Value Fund III. He gave a review of the firm and its organizational structure. The principals have more than 25 years of professional experience and about 10 years investing in the value-add sector. Exeter has employees involved with construction and development, leasing space and property management, in addition to their investment professionals. This fund will be Exeter's third value-add fund. He reviewed their track record and clients.
Next he reviewed the strategy. Exeter has nine, fully staffed regional offices across the country. They rely on local deal-sourcing and have relationships with national banks and regional banks. They make sure the portfolios are well-diversified by geography. They add value by improving the physical plants of their buildings and through their strong relationships with heads of real estate and logistics at major retailers, consumer products companies and others who lease warehouses.
Mr. Fitzgerald briefly reviewed performance of their previous funds. He gave an overview of recently acquired assets. He believes the industrial sector should outperform other real estate sectors. He added that Exeter has the experience and track record of executing as investment managers and as operators. The fact that they do their own operating eliminates additional operating expenses.
The board asked questions.
Mr. Fitzpatrick left the room.
Mr. Glickman noted that the firm is growing so PCA believes there is some expansion risk. As they sell their existing assets that will mitigate that risk. In the meantime, there will be a bit of stress on the organization. PCA recommends an investment of up to $30 million.
Ms. Fink added that large industrial is an interesting space tied more to the consumer economy than manufacturing. She believes Exeter's value-add approach is a reasonably risk-controlled way to generate attractive returns. She recommended a $30 million investment.

On a motion by Mr. Mullaney and seconded by Mr. Fay, it was unanimously
VOTED: to approve a $30 million investment in Exeter Industrial Value Fund III, L.P.

Mr. Glickman introduced IC Berkeley Partners as an up-and-coming firm. Their approach to investing in the industrial space is specialized at the local level. They are owner-operators and not allocators. Berkeley Partners' properties are smaller and PCA believes the fund provides more diversification within the industrial warehouse space.

Mr. Snegg reviewed the firm. The team specializes in value-add industrial for smaller businesses. It's consistently outperformed the broader industrial market over the past 20 years in terms of occupancy and rental rates. They have a diversified tenant mix with more than 700 tenants across many industries.
He explained their strategy. They acquire smaller, multi-tenant warehouses to not compete with larger operators and allocators. They do all their own leasing, construction and facilities management. They add value to the properties without having to depend on third parties. Historically the return across their funds has been 14.7%.
Mr. Novack reviewed the markets they focus on, mostly areas with population and economic growth. Going forward they expect to enter two to three new markets across the country as the recovery is taking hold. He reviewed some of the acquisitions made in the fund so far.
Mr. Snegg said the fund will be $100 million with a $120 million hard cap. They currently have $74 million of commitments. Any new investors come in as if they came in on the first close. It's a nice aspect as there has already been some substantial appreciation in portfolio.
The board asked questions.
Mr. Snegg and Mr. Novak left the room.
Mr. Glickman said this this investment would be complimentary to the Exeter investment. The risks with this investment are that the State may be their largest investor. PCA believes that they do have enough of an institutional-quality back office to service their customers. He noted that he is comfortable that at this point in the cycle there is going to be more take-up of space and this is a way to take advantage of that.
Mr. Glickman added that the recommendation from PCA is to invest up to $20 million but not to be more than 20% of the fund.
Ms. Fink suggested a $15 million dollar investment if they raise $100 million. If they raise over $100 million, she would recommend a $20 million investment.
Mr. Fay expressed concern over an investment being 20% of the fund. He suggested the board target a 15% maximum instead.

On a motion by Mr. Fay and seconded by Mr. Reilly, it was unanimously
VOTED: to approve an investment in IC Berkeley Partners III fund with an investment amount limited to a maximum of 15% of the fund.

VIII. State Street Global Advisors Presentation—Corporate Governance

Ms. Fink reminded the board that the investment policy requires the board to get value from corporate governance and proxy votes. The biggest place where the State has "vote assets" is in the equity index funds. She noted that SSGA has taken a more proactive role in corporate governance as of late.
Ms. Kumar said SSGA provides the stewardship required to make sure clients are covered in terms of environmental, social, and governance engagement with companies. SSGA pools all their holdings and vote all proxies in the same way. This approach increases the amount of weight the firm carries. SSGA has their own voting policies aligned by six geographic regions that have policies suited to the local customs. They have minimum standards which may exceed what local law provides.
She gave an overview of the scope of SSGA's voting. Last year they voted proxies in 14,000 companies. Overall SSGA would rather engage and work with companies rather than vote against them. Statistically, they vote against companies about 11% of the time. On shareholder proposals, they vote against management about 34% of the time and that number is up. The kinds of shareholder proposals they're seeing, particularly in U.S. are changing in nature. With stewardship responsibilities increasing as well as clients getting more interested, SSGA is moving the dial a bit on what they're

pushing. In 2014 the biggest change in the U.S. voting related to board refreshment and director succession. SSGA adopted a new tenure policy. They looked at 5,600 listed companies and saw that the average board tenure in the U.S. is 9 years and compared that number to outside the U.S. In companies with board members serving more than 13 years, they started voting against such long-tenured directors. SSGA continues to improve their engagement with companies with 74% of engagements inside the U.S. They are also increasing their engagement outside the U.S.

Ms. Kumar gave an overview of the current proxy season. This year was characterized by activism. Compensation also continues to be a big issue. Investors are looking for more pay-for-performance connections and for structures tied to long-term shareholder returns. She noted that UK and European shareholders have fought more against compensation in banks as it is far more political there.

The board asked questions.

IX. Legal Counsel Report

There was no legal counsel report.

X. CIO Report

Ms. Fink said the portfolio was up 0.5% in the month, which puts is at 11.9% fiscal year to date. The portfolio continues to look good on three-year basis with a 7.5% return and about 7.5% risk. This return per unit of risk is better than the bottom-up benchmark and 60/40 basic allocation. The program is doing well on a long-term basis.

On a short-term basis, April didn't perform as well. The portfolio lagged the bottom-up benchmark and the 60/40 blend. The defining market move in April was a sizeable rotation out of small-cap indexes, causing meaningful underperformance. The Russell 2000 was down almost 4% on the month at the same time as the large cap, S&P 500, was up 0.75%.

On a longer-term basis, small caps have outperformed larger caps. Over the last ten years, small caps have outperformed large caps by about 1% a year.

She noted that the small-cap rotation also impacted the hedged equity funds in the month. The real return hedge funds had a good month. Overall, the hedge fund portfolio outperformed the fund-of-funds composite index.

She said fixed income had a good month with U.S. treasury rates down. The portfolio had a 0.9% gain in core fixed income. Floating rate loans didn't do quite as well. They were up 0.1% and underperformed the benchmark. The GILBs benefited from the tightening of rates.

She said overall, the board should look for the diversified portfolio to continue to deliver solid returns.

XI. Treasurer Report

Treasurer Raimondo thanked the board and commended them on their continued work, particularly the breadth of their oversight from the defined benefit to defined contribution to 457 plan and college savings portfolios.

There being no other business to come before the Board, on a motion by Ms. Reback and seconded by Mr. Giudici, the meeting adjourned at 11:48 a.m.

Respectfully submitted,

Gina Raimondo

Gina M. Raimondo
General Treasurer