State Investment Commission

Monthly Meeting Minutes
Wednesday, June 25 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, June 25, 2014 in Room 205, State House.

I. Roll Call of Members

The following members were present: Mr. J. Michael Costello, Ms. Faith LaSalle, Ms. Paula McNamara, Mr. Thomas Mullaney, Mr. Frank Karpinski, and General Treasurer Gina Raimondo. Mr. Reilly was available by phone for the private equity recommendation.
Also in attendance:
Mr. Thomas Lynch of Cliffwater, alternative investment consultant to the Commission; Mr. Hans Swildens and Mr. Roland Reynolds of Industry Ventures; Ms. Patricia Roberts and Mr. Christopher Nikolich of AllianceBernstein; Mr. Cameron Lochhead and Mr. Greg Nordquist (by phone) of Russell Investments; Mr. John Burns and Mr. Allan Emkin of Pension Consulting Alliance (PCA), general consultant; Mr. Greg Balewicz of State Street Global Advisors (SSGA); Ms. Gail Mance-Rios of the Rhode Island Higher Education Assistance Authority (RIHEAA); Ms. Sally Dowling of Adler Pollock & Sheehan P.C., legal counsel; Ms. Anne-Marie Fink, chief investment officer, Mr. Vincent Izzo, cash manager for the state, and members of the Treasurer's staff.
Treasurer Raimondo called the meeting to order at 9:03 a.m.
Mr. Thomas Fay, Ms. Marcia Reback and Mr. Andrew Reilly were absent.

II. Approval of Minutes

On a motion by Ms. McNamara and seconded by Mr. Mullaney, it was unanimously
VOTED: to approve the draft of the minutes of the May 28, 2014 meeting of the State Investment Commission.

III. Private Equity Recommendation—Industry Ventures Partnership Holdings III, L.P.

Mr. Lynch introduced Industry Ventures as a hybrid strategy in the venture capital space.
Mr. Swildens gave a review of the firm. The firm specializes in venture capital. They manage almost $2 billion of institutional money, mostly from pension funds.
He went on to review the firm's investment strategies. They have two types of funds: a liquidity fund comprised of companies that are at later stages in their lives with $30 million to $200 million in revenue and a Partnership Holdings set of funds that invests in early part of the venture capital market in high growth, innovative companies.
For the current Partnership Holdings fund, they have closed on $100 million in commitments, including from three state pension funds. Mr. Swildens noted that by specializing in venture capital, the firm is unique in the asset class. The firm has a very big data set and a lot of relationships.
He reviewed the experience of the team. They are the largest team focused on secondary strategies in the venture market. They have invested across multiple market cycles and are pioneers in the strategy.

Mr. Reynolds added that the Partnership Holdings strategy has a unique window of opportunity. The fund began making investments in the 3rd quarter of last year.
He reviewed the current portfolio. The portfolio is comprised of 22 investments for almost 50% of the total committed capital. The investments in the portfolio have already increased in value. They expect the portfolio to be valued at 1.4 times cost as of 3/31/14. He noted that new investors will have an immediate gain. He said there is an opportunity for a fee reduction on a separate account when paired with a larger commitment to the core partnership.
Mr. Reynolds said their strategy is a unique hybrid strategy which includes investments in early and mid-stage venture capital assets. The intention is to create downside protection and faster time to liquidity while preserving upside potential.
The fund focuses on the small end of the venture market and high growth companies through a unique combination of primary fund commitments, secondary purchases of early-stage limited partnerships, purchases, and direct co-investments into companies.
The team expects to invest 40% of the portfolio in primary commitments to small venture funds at inception, another 40% into early secondary transactions at deep discounts in small fund managers, and 20% of the portfolio directly into companies alongside underlying fund managers.
He reviewed the opportunities they see in the market. He noted that small venture funds have outperformed large funds by a significant margin over a 15-year period. This trend is likely to continue in the future as the overall commitments to the asset class are down substantially. Also, 85% of all the exits of venture-backed companies actually happen in the M&A markets, which is easier for smaller investments to access.
Mr. Reynolds reviewed the fund terms. He said they have a preferred return of 6% and a significant general partner commitment of 2%. He reiterated that this investment offers a unique window of opportunity to receive immediate gain with unusual visibility into the 22 investments already. The fund creates the opportunity for outsize returns through exposure to the small end of venture market. The strategy is designed to generate attractive returns through M&A exits and is not reliant on the volatile IPO market.
The board asked questions.
Mr. Swildens and Mr. Reynolds left the room.
Mr. Lynch said Cliffwater recommends a $25 million commitment. In terms of portfolio fit, Cliffwater sees venture capital as a favorable asset class. In terms of the ERSRI's portfolio, there has been very little done in venture capital in the last few years. Currently venture stands at about 18% of the private-equity allocation with most of it invested prior to 2008. He added that there are no other firms that implement the strategy that Industry Ventures has. They are a high quality firm with deep knowledge in the space and they execute it with discipline.
The board discussed the recommendation.

On a motion by Mr. Mullaney and seconded by Ms. McNamara, it was unanimously
VOTED: to approve a $25 million investment in Industry Ventures Partnership Holdings III.

A motion was then made by Mr. Costello and seconded by Mr. Mullaney and it was unanimously
VOTED: to move the item on the agenda pertaining to the addition of short-term investment provider.

IV. Addition to List of Short-Term Investment Providers: U.S. Bank

Mr. Vincent Izzo, cash manager for the state, asked the board for approval to add U.S. Bank to the short-term investment lineup. He noted it is the fifth largest commercial bank in the country and is well capitalized. He explained the bank wouldn't necessarily provide any new services or products right away; once they were on the list, the bank would only receive deposits if its rates were competitive with our current providers. Mr. Izzo noted the bank meets all the criteria for short-term investments providers, except having a AAA rating from Moody's and Standard & Poors. Since the global financial crisis, none of the bank short-term investment providers have AAA ratings. He noted the investment policy allows for the board to approve a bank even though they don't meet all of the criteria. He said any product from U.S. Bank would be FDIC insured or 102% collateralized.

On a motion by Mr. Costello and seconded by Mr. Mullaney, it was unanimously
VOTED: to approve the addition of U.S. Bank to the short-term investment lineup pending review by legal counsel.

Treasurer Raimondo asked for an update on the Ocean State Investment Pool.
Mr. Izzo said the fund ranges from $420 million to $500 million depending on monies committed. It is heavily funded by bond proceeds. The interest rates hover around 0.10%, better than prime money-market funds, which are about 0.02%. He said Fidelity continues to reach out to cities in any towns to promote the fund.

V. Infrastructure Consultant Extension

Ms. Fink reminded the board about the infrastructure allocation approved a year ago. At the time, Judy Chambers from PCA was hired on a project basis to complete the infrastructure RFI, which resulted in the allocation to Industry Funds. Going forward, the goal is to continue to invest in infrastructure, both through private partnerships and also publicly traded master limited partnerships. In order to do so, she believes staff needs consulting advice on a systematic basis. She proposed an extension to the contract with PCA to add them as infrastructure advisor for $75,000 a year on a retainer basis.

On a motion by Ms. McNamara and seconded by Mr. Costello, it was unanimously
VOTED: to extend the contract with PCA to add an infrastructure advisor on a retainer basis.

VI. CollegeBound*fund* Quarterly Update

Ms. Roberts gave a brief summary of CollegeBound*fund*. The fund has $7.8 billion in assets under management of which $356 million is from Rhode Islanders. There are approximately 427,000 accounts nationally and about 25,000 in Rhode Island as of May 31, 2014.
She said the CollegeBound*fund* remains the second largest advisor-sold program in the country. The fund is fifth overall in terms of size. She noted most of the assets in the fund are in the age-based moderate and age-based aggressive-growth portfolios.
She reviewed the recently added Morningstar Index portfolios. As of May 30, the Morningstar option has about $2 million in assets, of which 25% of all the assets have come from Rhode Island.
Ms. Fink asked if this participation rate is what they had expected.
Ms. Roberts said yes and added that they are hearing from advisors across the country who are very excited about the offering because it is unique in the advisor space. AllianceBernstein has received a number of rollovers from other programs where investors are interested in age-based portfolios with a lower fee structure.
Mr. Nikolich gave a performance review of the funds on a year-to-date basis through May 31, 2014. He noted that in some cases the numbers are misleading given what the capital markets have done in the last couple of weeks.
He reviewed the performance, starting with the single-fund portfolios. The stable value fund is an attractive option in its strategy, with 0.67% return year-to-date. This option is the largest stand-alone

allocation at about 10% of all the assets. With the individual equity funds, one thing that has been weighing on performance has been the outperformance of US large cap versus international equities. The small-cap growth portfolio has been a stellar performer over 1, 3, 5, and 10 years relative to the benchmark. Within the active age-based portfolios, the more aggressive funds with higher levels of equity exposure have outperformed the moderate and the conservative. All the performance numbers look even better through the first three weeks of June.
Mr. Costello asked questions regarding AllianceBernstein's performance and the board discussed.

A motion was then made by Mr. Mullaney and seconded by Mr. Costello and it was unanimously
VOTED: to move the item on the agenda pertaining to the equity replacement strategies discussion.

VII. Equity Replacement Strategies Discussion

Ms. Fink said she and staff are constantly looking for opportunities that provide an asymmetric payoff, seeking investments that can gain more on the upside than they participate on the down side. The equity market is by far the portfolio's biggest risk with the overall portfolio having approximately 0.9% sensitivity to equity market moves (beta).
She reminded the board that a year and a half ago the board discussed buying some put protection for the portfolio. Staff did an extensive analysis and at the time the SIC decided pricing was unfavorable. She said at the current time a risk reversal position looks interesting. She explained how this position works; it entails selling a 10% out-of-the-money put and using the proceeds to buy a call so the entire position requires no cash. Currently a 3.5% out-of-the-money call can be purchased on a cashless basis. It would replace outright equity exposure. This position would protect against the first 10% of a down move. Downside after that would be one for one. The call would provide upside participation. What makes this option interesting is where the pricing is right now. Essentially the position protects against 10% of the downside and only gives up 3.5% of the upside.
She suggested considering this in lieu of the equity overweight. The position would be paired with a reduction in the long exposure. She noted that one thing to be aware of is that the option position does not participate in dividends. Secondly, they would want to transact in S&P 500 just because it has the best liquidity. She said they would recommend using Russell. They would have to factor in trading costs and also an oversight fee to Russell. She then gave a brief overview of the analysis that was done.
Mr. Nordquist noted there's been a great run-up in the markets. After the most recent market crisis, there was interest in protection early on but it was expensive. As the markets have recovered, the landscape has changed. Russell has developed a 'heat map' framework that helps them guide clients to when option strategies make sense. Recently, the markets have had a great run-up so some of the costs of protection are very low. Funded statuses have improved a lot so Russell is seeing a lot more interest in risk-reversal and even outright protections.
The board asked questions.
Ms. McNamara noted she understands the unique opportunity, but expressed concern that this kind of investment is out of her comfort zone considering the beneficiaries of the plan.
Treasurer Raimondo also expressed concern over the limited number of state investment staff and increasing active investment at this time.

VIII. Global Public Equity Allocation

Ms. Fink introduced PCA for a briefing of the long-only equity portfolio. This allocation is the largest in the portfolio.

Mr. Burns described the portfolio as passively managed to efficiently capture equity market returns. The risk associated with equities is growth risk. The portfolio is broadly diversified globally. Unusually the dividend yield is higher than the bond market yield. The management fees of this portion of the portfolio are very low. He went on to review the funds that are in the portfolio. The fees are approximately 0.03%.

He said this approach is a very efficient way of getting equity exposure. The policy of this portfolio is allocated to 50% US and 50% non-US.

He reviewed the characteristics of the underlying portfolios and industry weights. He went on to compare the portfolio versus the world equity portfolio in terms of exposure. Coincidentally, the world equity portfolio is very close to 50/50, though it is not always that way.

He reviewed the countries and the companies in the portfolio. Some of the biggest holdings in the U.S. are Apple and Exxon. He noted that historically companies come in and out of the top 10 list. In non-U.S. markets the portfolio has less exposure to consumer goods and health care holdings than in the U.S.

Mr. Emkin added that the globalization leads to a more global portfolio, because a big percentage of the earnings of non-U.S. companies are outside their home countries. Holding non-U.S. stocks doesn't give an exposure to any one region or one country; the portfolio is constructed to take advantage of every opportunity.

Mr. Burns said that at 50/50 U.S./non-U.S. the portfolio is more globally diversified than a typical large U.S. plan. He noted that PCA is seeing their clients and the industry overall moving portfolios more to 50/50 exposure for diversification and risk management.

He reviewed a chart with five year rolling returns. At different times there can be a big difference in returns from the U.S. and the non-U.S.

He talked about the small-cap stocks exposure in the portfolio. He said small-cap stocks tend to have bigger exposures to their local markets and offer some characteristics that are different than typical large-cap stocks. He noted that the portfolio has a gap with no non-U.S. small-cap exposure. He described the characteristics of a non-US equity index with small caps and compared it to the portfolio's current index exposure. He noted that investing in one versus the other won't change the portfolio significantly. In terms of performance, small-cap has outperformed in the last 10 years, but they don't outperform every year and are currently more expensive than large caps. He said both indices have almost the same standard deviation.

Ms. Fink asked Mr. Balewicz how fees would change if they were to switch to the all-cap international index, the I.M.I. Mr. Balewicz said fees are very low and to add the small cap would increase fees by 0.02% to 0.03%.

Mr. Burns went on to review the equity allocation's currency exposure. He noted that currency is a very complex topic and ERSRI does not hedge its currency exposure. He said return is shown as one return that includes local market moves and currency impacts. Over a long time frame, currency is neither helping nor hurting.

Ms. Fink noted that the portfolio is more volatile with the currency exposure. Over a sufficiently long period of time there is no reason to hedge currency as it generates no inherent return, but there will be volatility in the interim. The question for the board is whether they want staff to explore hedging out half or all of the currency exposure, or just stick with current policy and accept the volatility.

The Treasurer said the board could discuss this when there is a light agenda or a future retreat.

IX. Legal Counsel Report

There was no legal counsel report.

X. CIO Report

Ms. Fink said May was a very strong month in the markets due to improved economic activity and confidence. Though GDP declined in the first quarter, the improvement of the past few months suggest the slowing was entirely winter related. Global equities rose 2% in May. At the same time the Fed continued to taper its asset purchasing, while messaging that interest rates are likely to stay low for long. Core bonds were up 1% in the month. These moves caused the portfolio to rise 1.66% on the month, which is in line with the 60/40 portfolio and a little ahead of the bottom-up benchmark. Fiscal year-to-date, the portfolio is up 13.7% with risk below 7.5%. It remains better than the bottom-up benchmark and a 60/40 allocation. The annualized standard deviation has come down significantly over the last two years. Part of that is the market and part of it is the moves made by the SIC to improve the portfolio. She added that the alpha has been a little disappointing recently and staff continues to monitor it. The annualized Sharpe ratio, which measures return per unit of risk, has stayed steady. Private equity and real estate had a particularly strong month relative to benchmarks. In the bank loan portfolio, WAMCO had an uncharacteristically underperforming month at 0.3% vs. the benchmark at 0.5%

Ms. Fink gave an update on staff activity. She said they are working on an RFP of a manager of publicly traded infrastructure stocks or MLPs. They are looking to investigate that opportunity further.

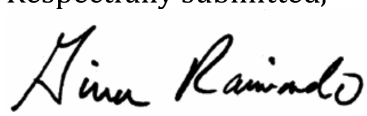
XI. Treasurer Report

Treasurer Raimondo gave an update of the most recent Retirement Board meeting. She said the retirement board voted unanimously to accept the actuary's recommendation for the experience study and valuation. She also noted that Mr. Emkin presented at the meeting, where he described the added value of the SIC by managing risk and generating strong long-term returns.

Treasurer Raimondo welcomed Ms. Faith LaSalle to the board. She thanked the board and commended them on their continued work.

There being no other business to come before the Board, on a motion by Mr. Mullaney and seconded by Mr. Costello the meeting adjourned at 11:02 a.m.

Respectfully submitted,



Gina M. Raimondo
General Treasurer