

**STATE OF RHODE ISLAND
INVESTMENT COMMISSION MEETING**

**MID-MONTH MEETING
JANUARY 13, 2009**

MEMBERS OF THE STATE INVESTMENT COMMISSION

Hon. Frank T. Caprio, Chair

**Mr. J. Michael Costello
Mr. Robert R. Gaudreau, Jr.
Dr. Robert J. McKenna
Mr. Andrew K. Reilly**

**Ms. Rosemary Booth Gallogly
Mr. Robert Giudici
Ms. Marcia Reback
Mr. John R. Treat**



State of Rhode Island and Providence Plantations
Office of the General Treasurer

Frank T. Caprio
General Treasurer

**RHODE ISLAND STATE INVESTMENT COMMISSION
MEETING NOTICE**

The next meeting of the Rhode Island State Investment Commission has been scheduled for Tuesday, January 13 at 9:00 a.m. in Room 135 of the State House.

AGENDA

1. Membership Roll Call
2. Approval of Minutes
 - State Investment Commission Meeting held on 12/17/08 *
3. Short Term Investments Policy Guideline Update
4. General Consultant Review – Pension Consulting Alliance
 - Asset Allocation – Passive Implementation Recommendations
5. Passive Investment Review – State Street
6. Legal Counsel Report
7. Chief Investment Officer Report
8. Treasurer's Report
9. New Business

* Commission members may be asked to vote on this item.

POSTED ON WEDNESDAY, JANUARY 7, 2009

**State of Rhode Island and Providence Plantations
STATE INVESTMENT COMMISSION**

Monthly Meeting December 17, 2008

A State Investment Commission (SIC) meeting was held in Room 135, State House, Providence, Rhode Island on Wednesday, December 17, 2008. The Treasurer called the meeting to order at 9:10 a.m.

Membership Roll Call. Present were: Mr. Michael Costello, Ms. Rosemary Booth Gallogly, Mr. Robert Gaudreau, Dr. Robert McKenna, Ms. Marcia Reback, Mr. Andrew Reilly, Mr. John Treat, and General Treasurer Frank T. Caprio. Also present were: Mr. Kenneth E. Goodreau, Chief Investment Officer; Ms. Sarah Dowling, of Adler Pollock & Sheehan, Mr. David Ursillo, of Rodio & Ursillo, Legal Counsel to the Commission; Mr. John Burns of Pension Consulting Alliance, General Policy Consultants to the Commission; Ms. Lisa Tyrell, of State Street Corporation; and other members of the Treasurer's staff. Mr. Robert Giudici was not present.

State Investment Commission Minutes. The Treasurer entertained a motion for approval of the minutes. Dr. McKenna moved, Mr. Costello seconded, and the following motion was passed. The following members voted in favor: Mr. Costello, Dr. McKenna, Ms. Gallogly, Mr. Gaudreau, Ms. Reback, Mr. Reilly, Mr. Treat, and General Treasurer Caprio.

VOTED: To approve the Minutes of the December 3, 2008 Monthly meeting.

Treasurer Caprio suggested the agenda begin with Mr. Izzo's presentation of Short Term Investment Cash and Fiscal Management issues.

Short Term Investment Cash and Fiscal Management. Mr. Izzo began by commenting that the current market has increased our need to scrutinize our current providers beyond our normal due diligence. Protecting assets is the number one priority. Our focus today is to continue our best practices protecting our assets and expand our horizons to pick up add additional yield.

Mr. Izzo continued that due to current market conditions we are not making any investments in the corporate world (Commercial Paper). With that and current SIC guidelines, we find ourselves restricted to three to four providers. Presently we are overweight on some investment and vendor categories because we are unable to find safe alternatives.

Mr. Izzo proposed the following changes: (1) to increase exposure to Fully Collateralized CD's to a maximum of 50% total and 20% to any one vendor, (2) To increase exposure to Collateralized Deposits to a maximum of 50% total and 20% to any one vendor, and (3) the combination of Fully Collateralized CD's and Collateralized Deposits shall not exceed 75% or 35% maximum per vendor which is our current guideline.

Mr. Izzo explained that these investments are fully collateralized with a third party and present no risk to credit exposure of these institutions. Presently SIC guidelines do not dictate that CD's be fully collateralized; however current practice is that any CD investment requires full collateralization.

The Treasurer entertained a motion that we increase exposure to Fully Collateralized CD's increasing the total to 50% maximum exposure and 20% to one vendor and also increase

exposure to Collateralized Deposits to a total of 50% maximum exposure and 20% to one vendor, and the combination of both not to exceed 75% total or 35% maximum per vendor. Ms. Gallogly moved, Mr. Reilly seconded.

The Treasurer then opened the floor for discussion. Mr. Costello asked for a description of the collateral. Mr. Izzo explained the collateral would be 102% of the investment in US Treasuries or Government Agencies only and that corporate instruments are not allowed as collateral.

Mr. Costello asked how many vendors we anticipate. Mr. Izzo explained that we currently purchase CD's and collateralized deposits from three banks. If the proposed three additional banks are approved, our total would be five banks for CD's and an additional three for the CDARS program.

Ms. Gallogly asked if this policy is adopted, how much capacity we would gain since it was indicated that we are currently over the maximum on some guidelines. Mr. Izzo explained that this approval along with approval of the new vendors would enable us to have our portfolio back in line immediately.

Ms. Gallogly asked what the cost of the collateralization is. Mr. Izzo explained that the collateralization costs somewhere around 20 bps.

Ms. Gallogly asked for an explanation of PIP (Premium Investment Product). Mr. Izzo explained that this is a fully collateralized deposit which is somewhat like a money market and that the rates reset weekly. It is collateralized at 102% at a third party custodian.

The Treasurer called for a vote to adopt the motion to increase our exposure to Fully Collateralized CD's as well as Collateralized Deposits and the combination of both not to exceed the percentages as stated in the motion. The following members voted in favor: Ms. Gallogly, Mr. Reilly, Mr. Costello, Mr. Gaudreau, Dr. McKenna, Mr. Reilly, Ms. Reback, Mr. Treat and General Treasurer Caprio.

VOTED: To increase exposure to Fully Collateralized CD's to a total of 50% maximum exposure and 20% to one vendor and also increase exposure to Collateralized Deposits to a total of 50% maximum exposure and 20% to one vendor and the combination of both not to exceed 75% total or 35% maximum per vendor.

Ms. Gallogly then asked for a confirmation that we have not changed our guidelines with respect to Corporate Instruments but rather our practice. Mr. Izzo confirmed that Corporate Instruments are still an acceptable instrument however we are not doing anything with them.

Ms. Gallogly asked that the Commission be notified if a decision is made to go back into Corporate Instruments.

General Treasurer Caprio entertained a motion that before we invest any state funds in Corporate, it be brought back to the board for a vote. Ms. Gallogly moved. Dr. McKenna seconded and the motion was passed. The following members voted in favor: Ms. Gallogly, Dr. McKenna, Mr. Costello, Mr. Gaudreau, Mr. Reilly, Ms. Reback Mr. Treat, and General Treasurer Caprio.

VOTED: That any change to move back into Corporate Instruments shall be brought before the Commission prior to taking action.

Mr. Izzo continued his presentation regarding CDARS. He explained that when CDARS were approved, a restriction was made that all of the underlying banks meet the full SIC test necessary for vendor approval. This restriction has become difficult due to the timing of bank reporting. All of our CDARS investment deposits are FDIC insured since they are broken down into \$90+ thousand dollar increments so that interest is also fully insured. The FDIC insured worst case in the event of a failure is payment within 72 hours. Because of the recent heightened alert the FDIC is ready to react. All institutions participating in the CDARS program must be well capitalized which means that their risk base capital ratio must be at least 10%. The yield on the CDARS two week rate is estimated at over 80 basis points above our current yield on investments. Due to the two week investment period required for CDARS, we would not be investing large sums of money.

Ms Gallogly asked for confirmation that FDIC guaranteed investments is like investing \$100,000 in US Treasuries. Mr. Izzo confirmed and added that there is a \$50M limit on this program.

Ms. Gallogly asked if we had formally adopted \$250,000 in FDIC insurance when we considered this program. Mr. Izzo explained that the program was not increased and that it is still at the \$100,000 limit per institution. CDARS investments fall under the caps within the CDs category so they are subject to the 50% total, 20% to one vendor.

Ms. Gallogly asked if we would know exactly where our money is invested. Mr. Izzo explained that we would be provided with a report providing this information.

Mr. Costello asked if we have a restriction as to the amount which can be invested in the CDARS program alone questioning whether conceptually it could go to 100%. Mr. Izzo explained that it could go to \$50M which is the limit of the CDARS program for institutional investor.

Mr. Reilly asked which institutions have been approved to take part in this program. Mr. Izzo explained that we have been approached by Washington Trust, Sovereign Bank, and Independence Bank in Rhode Island. He added that all the CDARS from different vendors are the same.

The Treasurer entertained a motion that the SIC requirement that the underlying banks meet the full SIC test be waived for participation in a CDARS program due to FDIC insurance and our investment would be below the FDIC limits. Ms. Gallogly moved. Dr. McKenna seconded and the following motion was passed. The following members voted in favor: Ms. Gallogly, Dr. McKenna, Mr. Costello, Mr. Reilly, Mr. Gaudreau, Ms. Reback, Mr. Treat and General Treasurer Caprio.

VOTED: To waive the SIC requirement that the underlying banks meet the full SIC test for participation in a CDARS Program.

Mr. Izzo addressed the need to modify the Return on Asset requirement within our investment guidelines to be as follows: If an institution should fail the Return on Asset Requirement test, the Treasury Investment Department would ask the Commission to allow the vendor to be placed on an official watch list for up to two quarters but to continue to purchase

instruments from them with the requirement that these be fully collateralized. If the institution's failure to meet the Return on Asset requirement exceeds the two quarter grace period, operations with them will be suspended. Emphasizing the need for modification, he further explained that presently there are two to three banks which could be in the suspend category with next quarter's reporting.

Mr. Costello asked what would be the down side of not agreeing to this proposal. Mr. Izzo explained that it would result in further constriction of investments and possibly exceeding policy guidelines.

Mr. Costello questioned that with the increase in Investment providers, would we be able to continue with the higher standard? Mr. Izzo explained that we could, however he would probably be before the Commission next month for additional vendor approvals. Although two out of the three are full service providers we could find ourselves without a vendor to purchase Discount Notes since our main provider may be suspended.

Mr. Goodreau expressed his concern that we may find in the near future all of the vendors will be on a watch list or in violation due to our strict guidelines. He reiterated the need to keep to the higher standards; however we may find ourselves with a main concentration with one vendor. We have been making investments according to policy to the extent we can, however in another month we may have another violation and/or find that there is another product not available to us or that we have cash available without a place to put it.

Mr. Costello asked Mr. Izzo to speak specifically regarding UBS's suspension and the products we purchased from them. It was explained that UBS was a Money Market provider and through Paine Webber we purchased Discount Notes, Commercial Paper, and other instruments. They are both suspended. Mr. Izzo added that presently First Tennessee Bank has been our biggest provider of US Agency Discount notes and they are in danger of being suspended if we do not adopt a policy change.

The Treasurer asked Mr. Izzo to explain who First Tennessee is since it is not a name widely recognized. First Tennessee is a provider of US Agency Discount notes exclusively supported by the government.

Ms Gallogly asked if we could take the money we would normally invest in US Agency Discount notes and invest it in Collateralized CD's. That would address First Tennessee however Webster Bank is currently on a watch list by Veribanc and we will probably lose these two vendors. The concern is for future guideline failures.

Mr. Costello expressed his reluctance to change the safety standards due to the current environment without a full understanding of the various options available. He spoke in favor of using other investment options to solve the problem rather than change the standard.

There was a discussion as to who is currently providing us with CDs and the need for diversification. Our current investment is mainly fully Collateralized CD's where the risk has been removed.

The Treasurer added that the standard which requires four out of six quarters' positive ROA was important when we were investing in institutions, however our current investments are not reliant on their credit quality but on collateralized CDs and Deposits backed by the US Government. We have taken the underlying credit risk out of the equation.

There was a discussion regarding which of our investments are not fully collateralized. It was explained that Money Markets are technically not fully collateralized although the instrument only invests in Government securities. PIPS are also fully collateralized.

Mr. Reilly concurred with Mr. Costello. He suggested that we temporarily suspend this test until we can identify larger pool of banks and that the Commission stays on top of this on a meeting by meeting basis. Mr. Izzo suggested he would report back to the Commission at each meeting on the status.

Mr. Izzo stated that in line with best practices, we have met with John Burns of PCA regarding our guidelines and we will be reviewing our fund with similar pension funds to explore best practices and look at products within our guidelines that can enhance our portfolio.

Ms. Gallogly asked if we could continue to work within the guidelines with the adopted changes. Mr. Izzo explained that he will do his best to get the guidelines back in line and that we can do this until the next vendor is unable to meet the ROA guideline.

The Treasurer asked Mr. Izzo to address the yield on US Agency Notes versus CD's or collateralized deposits. Mr. Izzo explained that the issue is duration and although the yield is less on Discount Notes the time requirement is an issue. CD's require a minimum time investment of seven days and sometimes we cannot extend seven days. We would then put more funds in Collateralized Deposits which increases the risk of being above the guidelines. Collateralized Deposits can give us a pickup in yield of 40-50 bps.

The Treasurer suggested that the Commission give additional room in the collateralized deposits. Mr. Goodreau added that the issue is not yield but of diversification. There is more policy risk in the product than in the vendor. The problem is the demand for safe paper and the availability of product. If we cannot find available product we are forced into over allocation or less diversity. If we can handle some of this issue through an increase in vendors we are confident in this method.

Mr. Izzo suggested that we work within the first two approved changes to the guidelines and report back to the Commission in January as to how well we have been able to meet the guidelines and if necessary we can revisit the modification of Return on Assets Requirement.

Mr. Izzo then introduced Patrick Marr, Treasury Analyst, who has researched three providers who meet our needs in terms of safety, liquidity, and yield.

Mr. Marr reviewed the three providers, the first being Federated Investors; our interest in Federated would be strictly as a money market provider in their Government Money Market Fund. This fund is approximately a \$40 Billion dollar fund and Federated does meet all of our current guidelines. He further explained that the fund is composed of half Agencies and half Repos which are fully collateralized.

The Treasurer entertained a motion to add Federated Investors for short term cash managers to our approved list of providers. Ms. Reback moved. Dr. McKenna and Mr. Treat seconded and the motion was approved. The following members voted in favor: Ms. Reback, Dr. McKenna, Mr. Treat, Mr. Costello, Ms. Gallogly, Mr. Gaudreau, Mr. Reilly, and General Treasurer Caprio.

VOTED: To add Federated Investors, Inc. to our approved list of providers for short term cash management.

Mr. Marr continued by presenting Wells Fargo as a full service provider who can provide us with Collateralized Deposits, Collateralized CD's, Agencies, Repos, and Government Money Market Funds. We are looking at them as both a bank and a broker since they meet all of our SIC Policy Guidelines.

The Treasurers entertained a motion to add Wells Fargo to our approved list of full service providers for short term cash managers. Ms. Reback moved and Dr. McKenna seconded and the motion was carried. The following members voted in favor: Ms. Reback, Dr. McKenna, Mr. Costello, Ms. Gallogly, Mr. Gaudreau, Mr. Reilly, Ms. Reback, Mr. Treat and General Treasurer Caprio.

VOTED: To add Wells Fargo to our approved list of full service providers for short term cash management.

Mr. Marr continued by presenting US Bank as an additional full service provider. They too meet all of the Commissions policy requirements. They would be offering Money Markets, Agencies, Treasuries, CD's, Commercial Paper, and collateralized deposits.

The Treasurer entertained a motion to add US Bank to our approved list of full service providers for short term cash managers. Mr. Costello moved and Ms. Gallogly seconded and the motion was carried. The following members voted in favor: Mr. Costello, Ms. Gallogly, Mr. Gaudreau, Mr. Reilly, Dr. McKenna, Ms. Reback, Mr. Treat and General Treasurer Caprio.

VOTED: To add US Bank to our approved list of full service providers for short term cash management.

Mr. Izzo noted that all of these are pending legal review.

Treasurer's Report. The Treasurer confirmed his recent press release addressing whether any of Rhode Island Investment funds were involved in any way in the Madoff demise. He stated that none of our funds were involved.

The Treasurer proceeded with an overview of the presentation by Mr. Burns of PCA to address the active management portfolio and fixed income asset allocations in conjunction with the review and recommendation to keep our present asset allocation but to achieve that through a passive strategy reducing costs by up to \$12 million. Also, if we were to exit active managers when the market presented the opportunity we would not be forced to liquidate under duress and sell equities driving down the market. Choosing a time when the market was moving in the right direction would provide a more favorable price.

The Treasurer turned the meeting over to John Burns of PCA to discuss a memo that will cover our Equity Portfolio, US and non-US Investment Theory, History of Public Pension Funds, Results to this Fund, Theory Faults, why this structure is still used and finally recommendations.

Mr. Burns started by explaining one of the exhibits showing the rate of return on investments net of fees. Our present reports from our custodians are gross of fees. In the future State Street reporting will be net of fees. Additional exhibits show how other public pension plans have performed versus benchmarks.

In addressing the proposed work plan adopted in October 2008, there are several areas of policy and strategy the SIC is to consider. Most require extensive analysis and will take time, up to several months or years to implement. One item under review is the current Equity portfolios structure which could yield immediate benefits. Moving the portfolio away from sub-optimal active investment strategy will result in immediate savings in management fees.

Presently, we are paying approximately \$12 million per year in active management fees. The US Equity Portfolio is currently 58% actively managed and 42% indexed in an S&P500 Pension Fund. This is a common US Equity portfolio structure. The non US Equity portfolio is 100% actively managed. Public pension plans historically employ 100% active management in non-US Equity portfolio because of the belief that these markets are less efficient than US markets and active management should outperform the index fund. The theory is to take part of the portfolio and index it and then hire active managers to add value. (The combination of a stable, index funds and lower active management fees should provide excess returns.)

In the 1980's, public pension funds abandoned balanced manager mandates and adopted specialized manager mandates, fully invested in fixed income and equity portfolio management. This was further refined and classified as growth, value or core style managers. Investors could construct a portfolio of management styles that ensured coverage of a broad market preventing concentration in the portfolio.

This form of equity portfolio structure has not matched expectations. The active management portion has not added value relative to passive management index funds. If one constructs a portfolio of managers with diversified investment styles, the composite of portfolios and returns typically look like an index fund. As a result, the investor ends up with an index fund-like return (beta) with little if any (alpha) after fees. An index fund can be purchased very inexpensively, typically for 1 or 2 basis points.

With maturity, an active manager's investment process, organization and business focus typically has changed. Initially the product will have few assets and the management is focused. As the portfolio grows the focus becomes more on how not to lose money. The larger the asset base the higher the manager's revenue, but adding value becomes difficult. As a result the portfolio is managed with a tighter tracking error to the index (less active management risk). The investor is then paying active management fees for very little active management skill.

Hiring and firing of managers has associated costs. Due to performance issues, style drift, organizational change, personnel turnover, mandatory procurement re bidding requirements, etc. the cost of transitioning and repositioning a portfolio will generate a performance shortfall.

It is important point to stay focused on the composite portfolio of active managers and not individual managers. In reality, a five manager portfolio will probably yield 1 manager doing well, 3 doing fair, and 1 performing very poorly. The result will likely be underperformance of the benchmark after fees.

There is also a theoretical perception that indexing is a flawed strategy. Indexing methodology is based on market capitalization and is a buy and hold strategy. Some Market theorists maintain that it is guaranteed to have large allocations to overvalued stocks (large cap) and small allocations to undervalued stock. They believe active managers are necessary to avoid this flaw. This may be theoretically plausible true but index funds have survived many market cycles and active managers have not collectively added value over the same periods.

Some public pension plans have terminated the active component of their portfolio and done some of the following: indexed the equity portfolio, adopted portable alpha strategies, introduced other sources of value added, or a combination of all three.

In reviewing Rhode Island's US Equity results, two of five managers have added value net of fees from inception, three have not. Over the past ten years the U.S. Equity portfolio composite has underperformed the index by 25 bps net of fees. Since 1989 the U.S. Equity composite has underperformed by 57 bps net of fees. This compounded over 20 years on an average portfolio balance of \$1 billion results in a cumulative loss of \$100 million relative to a strategy that indexed the U.S. Equity portfolio.

Non-U.S. Equity results show one of the three active managers has added value net of fees since inception, two have not. Since the program inception, the fund was off 101 bps resulting in a loss of \$100 million relative to a strategy that indexed the non-U.S. Equity portfolio for the entire period.

Mr. Burns recommended that the SIC address the Equity structure issues in detail next year. He recommended that active managers be terminated and put into a broad market index funds portfolio pending a final decision on how to structure the U.S. and non-U.S./Equity portfolios. The fund will incur transaction costs but these will be recouped from active management fee savings.

He then reviewed the Universe exhibits. These exhibits represent public pension plans and public US Equity Composites. It compares 103 Public Pension plans. The median Pension Plan was off 21.6 % for the period ending September 30, 2008. During that period of time Rhode Island was minus 21.82% which equates to the 55th percentile. These numbers are all gross of fees. Average fees are approximately 25 bps which then need to be deducted.

The International Equity portfolio exhibits 50th percentile performance at minus 29.6 %. This includes public pension funds and equity portfolios that include stand alone emerging market allocations which not all funds have included. These will skew the data higher. Rhode Island's total International Portfolio exceeded the benchmark in the 1 year period. However; it was behind the benchmark in the long term.

Ms. Gallogly questioned if the numbers were net of fees. Mr. Burns explained that they were not and the benchmark would move higher if you take out the fees. The 25 bps would be the fees that you pay for active managers versus index funds which are basically 1 or 2 bps.

Mr. Treat asked how many cycles have the larger pension funds been 70% invested in index funds. Really large funds have to be 90% indexed because of the number of active managers you would need to hire. Indexing has been around since 1976. In closing Mr. Burns reconfirmed the key issue is for everyone to stay focused on the composite performance and not on the individual managers.

The Treasurer asked where the Commission would like would to take this. He explained that in preparing new ideas we have looked at investment guidelines and overall structure. He indicated that if we did want to exit a manager, there are legal and policy issues which need to be covered. Mark Dingley would summarize the process so that all information will be available when we are ready to discuss these issues. Treasury staff wants to provide these materials prior to our meetings in order for the Commission to have necessary time to review.

Mr. Dingley began by explaining that the statute requires that the SIC have an investment policy statement. In reviewing what the SIC presently has, it does not appear to be a unified statement, but rather a separate policy for each investment manager. Treasury staff is working with PCA to develop a policy statement which looks like a best practices statement. Currently, we have an asset allocation policy and then for each investment firm hired there is a letter of agreement which constitutes the investment policy for that particular investment allocation. Moving forward, as changes are made, we will need to amend each investment policy statement.

Legal Counsel Report. There were no legal developments for Counsel to report at this meeting.

New Business. There being no further new business, the Treasurer entertained a motion to adjourn. Ms. Reback moved, Dr. McKenna seconded and the following motion was passed. The following members voted in favor: Ms. Reback, Dr. McKenna, Mr. Costello, Mr. Gaudreau, Mr. Reilly, Ms. Gallogly, Mr. Treat, and General Treasurer Caprio.

VOTED: To adjourn the meeting.

There being no further business, the meeting was adjourned at 11:10 a.m.

Respectfully submitted,


Frank T. Caprio
General Treasurer