



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

Gina M. Raimondo
General Treasurer

Defined Benefit Investment Policy Statement

Approved by the State Investment Commission on February 26, 2014

I. Employees' Retirement System of the State of Rhode Island: Purpose

A robust state retirement system plays a critical role in recruiting and retaining the talented employees on whom the State of Rhode Island depends for quality public services, such as teaching in our schools, fixing our roads, protecting our environment and policing our streets. Pension assets exist to fund future pension payments, both in the near and long term.

II. Investment Policy Statement: Purpose

This document sets out investment objectives and policies for the Rhode Island State Investment Commission ("SIC") in investing the funds of the Employees' Retirement System of the State of Rhode Island ("ERSRI") as mandated by R.I. Gen. Laws §35-10-6(b): "The commission shall adopt a statement of investment objectives and policies consistent with the prudent person standard."

III. Adoption

The SIC adopted this policy on February, 26 2014 and will review it at least once every seven (7) years.

IV. Legal Authority

ERSRI was established effective July 1, 1936. *R.I. Gen. Laws §36-8-2.*

The SIC was established within the office of the General Treasurer with the General Treasurer as its Chair R.I. Gen Laws §35-10-1. The SIC is charged with the investment of ERSRI's funds (collectively, the "Fund"). *R.I. Gen. Laws §35-10-2.*

V. Fiduciary Responsibility

The SIC must act in accordance with the "prudent person" standard. The "prudent person" standard requires SIC members to discharge their duties solely in the interests of ERSRI participants and their beneficiaries with such care, skill, prudence, and diligence under the circumstances then prevailing that a person acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of like character and with like aims. In addition, the prudent person standard requires the SIC to diversify the investments of ERSRI so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so. *R.I. Gen. Laws §35-10-6(b)*

ERSRI expects Investment Managers to minimize costs to the full extent possible without compromising net investment returns.

VI. Ethics

Members of the SIC and the Staff advising them are subject to the State's Code of Ethics. *R.I. Gen. Laws §36-14-1 et seq.*

Members and employees of the SIC must not profit directly or indirectly from any investment transaction made by the SIC. *R.I. Gen. Laws §35-10-7(b).*

External Managers must sign Rhode Island's Investor Code of Conduct Pledge and Placement Agent Disclosure Certificate.

SIC members and Staff must disclose any material interests in financial institutions with which the SIC conducts business as well as any personal financial/investment positions that could be related to the performance of the Fund. They must refrain from undertaking personal investment transactions with the same individual with whom business is conducted on behalf of the Fund.

VII. Investment Philosophy

Retirement security is the priority of the SIC in overseeing the pension investments. In constructing its investment policy, the SIC considers three primary factors: the expected rate of return mandated by the ERSRI Retirement Board, characteristics of the pension plan, and investment characteristics.

The ERSRI Retirement Board, with the assistance of consultants, determines the pension fund's actuarial rate-of-return assumption. In 2011, the ERSRI Retirement Board adopted a 7.5% actuarial return assumption for the plan. The SIC seeks to build the investment portfolio to achieve this expected return over the 30-year actuarial time horizon.

Additionally, the SIC considers other characteristics of the pension plan. At this writing, the fund's projected benefit obligation meaningfully exceeds the assets currently held by the fund. The retirement system pays out more in benefits each year than it receives in contributions. Consequently the fund's investment horizon needs to balance its long-term obligations and shorter-term cash flow requirements. As such, investments must achieve a balance between seeking returns (to reduce the underfunding) and controlling risk (to meet annual cash flow needs).

In directing the portfolio, the SIC also considers the characteristics of investments and current market conditions. Investments are inherently unpredictable over the short term, being subject to the returns and risk delivered by the capital markets in any given period. The SIC strives for a portfolio that balances expected return and risk across asset classes to achieve the assumed actuarial return over the long term and provide retirement security for pension participants. Diversification of risks is a powerful tool to improve the potential return per unit of risk when investing. Minimizing the volatility of returns harnesses the power of compounding and generates stronger returns over time.

Given these considerations, the SIC is guided by the following:

Investment Beliefs

To maintain, or better yet improve, the pension system's financial condition, the fund seeks to equal or exceed the actuarial rate of return assumption over the long term. Therefore, the fund must prudently invest in volatile assets, seeking to use diversification to minimize risk while looking to attain the investment objective.

Asset allocation is the primary determinate of portfolio return and volatility. Making allocations across different asset classes and strategies is the fundamental focus of the SIC.

There is a return premium to risky assets. Given the investment objective and the plan's underfunding, the portfolio must take risk with its asset allocation to achieve the actuarial return assumption over time.

Numerous return drivers impact the plan including, but not limited to, funding uncertainty, contribution variability, liquidity premium (risk), capital markets return/risk, tail risk, and interest rate exposure. The SIC seeks to identify and measure return and risk drivers. However, many sources of risk/return are not fully measurable and can deviate from historical patterns. Quantitative risk measures often underestimate large negative market environments (tail risk). The fund's monthly disbursements (payments exceed contributions) limit the portfolio's ability to weather downturns (can be forced to sell low to raise monthly cash outflow). Therefore, diversifying return and risk drivers is a primary factor in asset allocation.

Diversification among investment types is a powerful tool to enhance the strength and stability of the portfolio. By designing a diversified portfolio, the SIC seeks to achieve strong, long-term returns. In determining the target mix of assets, the SIC considers:

- Expected rate of return for each asset class
- Expected variability of each asset class
- Expected correlations of each class's returns with those of other asset classes
- Expected performance of each asset class in response to different market environments
- Asset liquidity (ability to exit quickly at low cost)
- Actuarial rate of return assumption, investment objectives, funding status, cash flow profile, and risk constraints of the overall pension plan

The SIC recognizes there are costs and practical limitations around maintaining its target allocation. It allows for, and will monitor, latitude around its allocation targets.

Where staff resources are constrained, external managers shall be selected to implement investments. The state's resources will focus on hiring the most capable investment managers, prioritizing expected long-term, net-of-fee returns. The SIC seeks value for fees paid over the life of its investments.

Good governance of companies, in which the plan invests, can help drive returns and should be managed accordingly.

VIII. Corporate Governance Policies

a. Purpose

The SIC views its governance rights as an asset of the pension fund. By advocating for good governance practices and responsive corporate behavior, the fund expects to strengthen the long-term investment returns generated by the fund for its hardworking public employees and retirees.

b. Principles for creating long-term shareholder value

Charged with funding liabilities several decades into the future, the SIC has a mandate to generate performance over the long run. In seeking a return on its governance assets, the SIC focuses on four primary principles for generating long-term value:

- *Increase corporate board member accountability to shareholders*
- *Improve corporate board effectiveness through independent and rigorous decision-making*
- *Create value over the long term*
- *Upgrade transparency*

Increase board member accountability to shareholders

Corporate Board members represent shareholders. Yet, many standard practices for selecting and electing corporate boards often make directors more accountable to a company's chief executive officer and current board members than to shareowners. Lacking a mandate from shareholders, corporate boards often do not serve as a sufficient check on corporate senior executives and their overall decision-making. The SIC favors proposals that improve accountability of corporate directors to owners.

Improve board effectiveness through independent and rigorous decision-making

Effective corporate board decisions require debate among directors with diverse, independent, and informed perspectives. The SIC favors proposals that encourage companies to look broadly when identifying candidates for corporate board seats. By incorporating varied perspectives and experiences, and ensuring the majority of directors are independent of the companies and executive teams they oversee, better decisions should follow.

Create value over the long term

Long-term value creation requires effective management of three forms of capital: financial, physical and human. Shortcuts can create gains in the short run to the detriment of long-term earnings. By ignoring multi-year impacts, corporate management teams fail to create durable returns for ERSRI plan participants, since equities are valued based on expected cash flows over the long run. The SIC favors proposals that encourage corporate directors and leaders to measure and mitigate external risks and costs – environmental, social, regulatory, legal, geopolitical – that can destroy value in the long term.

Upgrade transparency

For shareholders to evaluate the effectiveness of corporate boards and managements, they need information. Too often companies hide behind competitive concerns or worries of market “short-termism” to avoid communicating with their shareowners. However, equities are priced based on companies' long-term prospects. With better information, shareholder understanding of companies' strategies will improve, creating more patience with promising plans. Access to all appropriate data enhances the effectiveness of decision-making. Therefore, the SIC favors proposals that improve

corporate directors' access to information, including access to company employees, shareholders, equity analysts and other informed parties.

c. **Corporate governance philosophy**

The SIC seeks to generate returns from its governance assets for the benefit of pension participants. Equity holdings give the pension fund ownership stakes in companies, and thus corporate governance rights.

Given the plan's structure and the characteristics of investments, the SIC is guided by the following:

Corporate governance beliefs

Since the pension plan has broad equity holdings in low-turnover strategies, the SIC has a longer-term perspective than most corporate executives or fund managers, elevating the importance of corporate governance to the ERSRI plan.

The primary methods for implementing corporate governance policy are voting proxies and engaging with corporate management teams.

Exercise of the SIC's fiduciary duties depends on how the shares are held:

Equities directly held by ERSRI require staff and any corporate-governance consultants to exercise corporate governance responsibilities in accordance with SIC priorities.

For shares indirectly held through commingled funds, the third-party, commingled-fund manager has standing as the equity holder, and the duty to vote shares. The SIC's role is to oversee the fund managers' effectiveness in generating value from corporate governance, as well as more generally.

d. **Corporate governance process**

As part of the vetting process when selecting managers, the SIC will evaluate managers on their ability to extract value from their votes. Consultants and staff will incorporate an evaluation of managers' governance capabilities (where appropriate) into their due diligence and recommendations. A copy of this Corporate Governance Policy will also be sent to all new fund managers. While corporate governance is one important consideration, the SIC will assess all the attributes that a commingled fund brings to the ERSRI portfolio, with the ultimate goal to maximize long-term, risk-adjusted returns for the ERSRI participants.

Staff and consultants will review the corporate governance record of its passive fund managers (where there is no opportunity to avoid underperformers through active stock selection) on an annual basis, and report to the SIC. For active fund managers, consultants and staff will include corporate governance as part of the ongoing monitoring of managers.

IX. Roles and Responsibilities

a. **State Investment Commission (SIC)**

The SIC is responsible for strategic asset allocation and final investment decisions and oversees Staff's day-to-day running of the Fund, consistent with the authority granted under Rhode Island law. The SIC is a fiduciary for the Fund.

The SIC establishes and maintains broad policies and objectives for all aspects of Fund investments. It seeks appropriate and consistent investment results, net of fees, for ERSRI members and beneficiaries, balancing the actuarial return assumption, current market opportunities, and risk levels. The SIC may delegate certain of its duties as appropriate. It receives periodic reports and recommendations for asset management from the Investment Consultants and Managers.

The SIC is comprised of up to ten members, with nine voting members; the Rhode Island General Treasurer is the chair of the SIC. The SIC meets monthly, with the ability to add or cancel meetings as appropriate.

Each member of the SIC and each member of the SIC's Committees are fiduciaries to the Fund. The duties of each fiduciary shall be discharged:

- Solely in the interests of ERSRI participants and their beneficiaries.
- For the exclusive purpose of providing benefits to eligible participants and their beneficiaries and defraying reasonable expenses of administering the Fund.
- With the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity would use in the conduct of an enterprise of like character and with like aims.
- By diversifying the investments of the Fund so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so.

Main Responsibilities

- Sets investment policy, asset allocation, Manager selection, and investment guidelines.
- Maintains overall responsibility for financial management of the Fund assets.
- Reviews Fund performance including risk monitoring.
- Monitors and evaluates Investment Consultants, Investment Managers and the Custodian.
- Reports major accomplishments and Fund performance to the General Assembly through the Comprehensive Annual Financial Report (CAFR).

SIC members are encouraged to participate in educational forums as available.

b. Investment Office

The Investment Office carries out the administration of the Fund on behalf of the SIC, led by the Chief Investment Officer.

Main Responsibilities

- Oversees the day-to-day operational activities of the Fund subject to policies established by the SIC.
- Formulates, evaluates, recommends and implements SIC decisions on investment policies and procedures for all asset classes. Conducts ongoing review and maintains the SIC Investment Policy Statement.
- Develops and/or reviews recommendations for improvements in policies, practices and procedures.
- Implements long and short-term asset allocation strategic plans set by the SIC. Develops programs to implement asset allocation decisions efficiently, including securities trading and cash management. Sets tactical asset allocation based on SIC policy allocation and practicalities

of vetting third-party Managers and diversifying vintage-year risk. Manages actual allocations within +/-2% of each asset type in the tactical asset allocation to accommodate market movements while minimizing trading costs.

- Generates search criteria for Investment Consultants; participates in the evaluation and selection of Investment Consultants; negotiates fees and contracts; and recommends termination of Investment Consultants if necessary.
- Develops search criteria for new Investment Managers; participates in the evaluation and selection of Investment Managers; negotiates fees and contracts; and recommends the termination of Investment Managers if necessary. Has ability to reduce Fund investments by no more than 2% of the Fund assets, when urgency requires action before next SIC meeting.
- Acts as signatory on investment accounts, and executes such documents as may be necessary to invest the Fund.
- Monitors and oversees the ERSRI external Investment Management firms, the internal investment portfolio, and Investment Consultants.
- Meets with Investment Managers to review performance and to monitor compliance with investment policies and procedures, and contractual guidelines.
- Monitors performance benchmarks, risk characteristics and performance attribution analysis for the Fund, asset classes and individual Investment Managers.
- Advises the SIC of cash flow requirements and the availability of funds for investment.
- Oversees investment education and training programs for SIC and Staff.

Chief Investment Officer (CIO)

As head of the Investment Office, the CIO:

- Reports to the Rhode Island General Treasurer.
- Directs the activities of the Investment Staff.
- Manages day-to-day oversight of the ERSRI investment portfolio, working with Investment Staff.
- Receives necessary training and education required to carry out duties on behalf of the SIC; is encouraged to attend industry conferences and educational forums as opportunities arise.

Investment Staff

The Investment Staff carries out the Investment Office activities to administer the Fund on behalf of the SIC and is directly responsible to the Chief Investment Officer.

- Works with the CIO to execute the Investment Office responsibilities.
- Receives necessary training and education required to carry out their duties on behalf of the SIC, and is encouraged to attend industry conferences and educational forums as opportunities arise.

c. Legal Counsel

The State Investment Commission hires external counsel to serve as its legal adviser.

Main Responsibilities

- Advises the SIC on applicable laws including open meeting and access to public records laws.
- Works with the Investment Staff and external Investment Consultants to negotiate agreements with third-party Investment Managers.
- Reviews documentation of Investment Managers and Consultants upon request.

d. **Bank Custodian**

Responsible for the safekeeping and custody of ERSRI's assets, the Custodian is hired by and responsible to the SIC.

Main Responsibilities

- Provides safekeeping and custody of all securities purchased by Managers on behalf of the Fund.
- Provides a monthly reconciliation of ERSRI assets from the Custodian bank's reports with each Investment Manager's statement.
- Values and monitors individual securities, including derivatives and the trades from which they emanate.
- Settles securities transactions in a timely manner.
- Maintains short-term investment vehicles for investment of cash not invested by Managers.
- Executes foreign currency transactions as needed by the Fund.
- Checks all Manager accounts daily to make sure that all available cash is invested.
- Collects interest, dividend and principal payments on a timely basis.
- Processes corporate actions.
- Files and monitors class action settlements on behalf of ERSRI.
- Prices all securities at least on a monthly basis, preferably on a daily basis contingent on asset classes and types of securities.
- Provides data and reports directly to the SIC on a monthly basis, as well as on an *ad hoc* basis as needed.
- Provides continuing education programs for the SIC and Staff.

e. **Investment Consultants**

The role of the Investment Consultants is to provide objective, independent third-party advice to the SIC and Investment Staff. Investment Consultants do not have discretionary decision-making authority on behalf of the SIC. The Investment Consultants provide research, evaluation, education, and due diligence for the SIC and Investment Staff. Investment Consultants have a fiduciary responsibility for the quality of the service delivered.

Main Responsibilities

- Recommend strategic procedures and processes.
- Prepare asset / liability or asset allocation studies upon the request of the SIC, recommending asset allocation policy.
- Assist with Manager structure, selection, monitoring and evaluation.
- Review the performance of the overall portfolio and/or its components.
- Execute special projects at the request of the SIC and CIO.
- Provide continuing education to the SIC and Investment Staff.

f. **Investment Managers**

Given resource constraints, the SIC hires third-party Investment Managers to manage portions of the portfolio consistent with a mandate for that portion of the portfolio.

Main Responsibilities

- Acts as an investment specialist on behalf of the SIC.

- Executes on a portfolio strategy a) within the specific mandate that has been developed specifically for the Fund in the case of separate accounts, or b) that is consistent with the Fund's mandate in the case of commingled accounts.
- Manages, purchases and sells assets and securities for the Fund in accordance with the assigned portfolio mandate.
- Communicates performance, performance drivers and major investments with the Investment Consultant and Investment Staff periodically (at least quarterly), and more frequently as needed.
- Monitors the Fund's formal agreements such as limited partnership agreements, subscription agreements, and side letters. Responsible for communicating any changes in these agreements with Investment Staff and Consultants.
- Wherever possible, serves as a fiduciary for assets under its management.