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# Washington State Investment Board Economically Targeted Investment Policy



**2005 Annual Report  
December 15, 2005**

## Introduction and Summary

The Washington State Investment Board (WSIB or Board) manages \$65 billion in assets for 34 separate state retirement and other trust funds. The Board conducts its investment activities in accordance with investment policies and procedures designed to maximize return at a prudent level of risk. Asset allocation explains over 90 percent of the variability of return. Accordingly, the WSIB invests in basic asset classes including public equity (both U.S. and non-U.S.), fixed income, real estate, and private equity to help control risk and ensure stronger performance overall.

This is the third annual progress report on the WSIB Economically Targeted Investment (ETI) policy approved by the Board in March 2003. This year's annual poll of the WSIB's private equity General Partners' (GPs') deal flow activity for the year ended September 30, 2005, shows consistent strength and improvement over the prior two years. Key findings include the following:

- ❖ 46 GPs looked at 1,223 Washington-based opportunities.
- ❖ 553 deals were still in the pipeline at September 30, 2005.
- ❖ 33 deals were completed.
- ❖ Venture capital and private equity firms continue to look at deals in the region.
- ❖ Not all deals get funded.

Washington is rich with investment opportunity and has earned the interest of and access to top quality GPs. The WSIB's GPs continue to actively seek quality opportunities based in Washington, and deals are getting done in Washington.

The WSIB believes the state of Washington is an excellent place in which to invest a portion of the trust funds under management by the Board. Nearly \$1.3 billion in value is currently held in the WSIB investment portfolio in Washington-based investments through its public equity, fixed income, real estate, and private equity investment programs. These investments were made consistent with the WSIB's statutory mandate. This \$1.3 billion investment in Washington-based companies represents 2.7 percent of the state's commingled trust fund, while the Washington Gross Domestic Product (GDP) is only 0.6 percent of the GDP for the investible universe within which we invest. More than \$5 billion in private equity commitments have yet to be called, representing significant capital ready to put to work as qualified investment opportunities arise. The Washington-based investments made by WSIB's GPs further leverage additional capital from other sources to put to work in the state.

The WSIB has made a strong commitment to facilitate access to and awareness of quality in-state investment opportunities. Further, it has devoted resources to implement that policy and to track future in-state investment activity. The WSIB continues to work with the Washington Technology Center (WTC) and other regional partners to access valuable Washington economic development networks, assist Washington companies achieve exposure to potential sources of capital, and provide feedback regarding educational and investor networking events.

## Overview of Policy

In March 2003, the Board adopted an ETI policy to communicate the role and responsibilities of the WSIB relative to such initiatives. ETIs are defined in this instance as investments having the primary objective of investment return to pension trust fund assets and the collateral objective of assisting the regional economy and the economic well-being of the state of Washington, its localities, and its residents.

In the ETI policy, the Board reiterated its "fiduciary duty to invest and to manage the entrusted funds in a manner consistent with statutes, regulations, Board policies, and the highest standard of professional conduct for the exclusive benefit of fund beneficiaries." The Board has established written policies and procedures for all its investments. The Board will continue to seek quality investment opportunities within the state in accordance with its established policies, statutory mandates, and fiduciary duty.

The Board requests its private equity GPs to report annually on Washington-based investments evaluated during the prior year. Private equity investments include securities that are not listed on a public exchange and are not easily accessible to most individuals. These investments range from initial capital in start-up enterprises to leveraged buyouts of mature corporations. Private equity investments are typically long-term commitments that may last up to 12 years or more. Although less liquid and perhaps more risky than publicly traded investments, private equity investments can offer higher returns than traditional public equity when employed as part of a larger balanced portfolio.

The WSIB's private equity portfolio originated in 1981 and is invested primarily in limited partnerships. Each partnership, which is managed by a GP, acquires or creates ongoing businesses or operating companies at the discretion of the GP. Ultimately, the companies are sold in the public market or to strategic or financial buyers, and only then can the true return on investment be accurately measured. To meet return and plan objectives, the WSIB's private equity portfolio has diversified investments in a broad cross-section of sub-sectors, industries, and geographic regions including Washington and other Northwest states.

The Board established a staff function to facilitate the exchange of information between its private equity GPs and appropriate parties with knowledge of quality in-state investment opportunities and, in accordance with the ETI policy, provide an annual report of WSIB's ETI activities to the Board, beneficiaries, Legislature, and Governor. This report presents the progress to-date of the WSIB policy on ETIs.

## Investment Environment

Although the WSIB portfolio contains asset classes other than private markets, much of the following report focuses on private equity and, more specifically, on venture capital. This is due to the fact that the policy reporting is focused on private equity, and much of the in-state investment activity of interest is focused on the venture capital arena. In addition, the venture segment traditionally has provided more detailed and summary data over longer periods of time and for more investment characteristics than other segments of the private equity industry.

According to Thompson Venture Economics, U.S. venture capital investing for the first nine months of 2005 totaled \$16.3 billion, up from \$15.9 billion for the same period in 2004. Although quarter to quarter investment activity has fluctuated, overall it has been fairly stable since the third quarter of 2003. The Life Sciences (Biotechnology and Medical Devices industries together) continued to dominate as it has for the past 13 consecutive quarters, capturing 26 percent of all venture investing in the first nine months of 2005. At the current rate, this segment is on pace to meet or exceed 2004's \$5.8 billion total. The Software industry remained the largest single industry category and garnered 21 percent of the venture dollars for the first nine months of 2005. Although Telecommunications investments have continued to languish in recent years, its Wireless investments have shown constant and steady growth.

Viewed by stage of development for the first three quarters of 2005, later stage funding stayed true to historical norms capturing 44 percent of the investment dollars as venture firms continued to support existing portfolio companies with follow-on rounds. Over 19 percent of all dollars during that period (\$3.2 billion) were in start-up and early stage companies; expansion stage companies accounted for 37 percent of all dollars.

In the first nine months of 2005, 653 companies received their first venture capital funding totaling \$4 billion. Of this, 69 percent went to start-up and early stage companies, 26 percent to expansion stage companies, and 5 percent to later stage companies. Most of the first time deals were in Software (25 percent) and Life Science (18 percent).

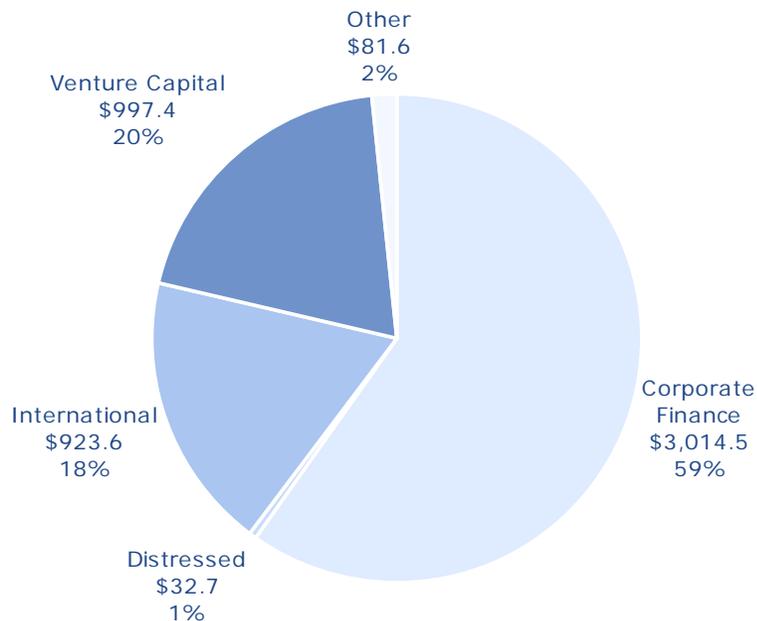
Private equity fundraising activity remained robust with 130 venture capital funds raising over \$17.4 billion and 122 buyout and mezzanine funds raising over \$54.1 billion during the first three quarters of 2005. These amounts already surpass the respective 2004 totals. Total venture fundraising is 62.1 percent higher than in 2004. Early stage funds continued to dominate with 47 funds, or 36 percent. The ratio of follow-on funds raised compared to first time funds was approximately 3-to-1.

A continuing issue in private equity is whether the industry has too much “overhang,” which is the amount of available or uninvested capital that has been raised by private equity funds. Excess capital may encourage too much competition for new deals and lead to overvalued transactions. Overhang may further result in over-investment in sectors that cannot support adequate rates of return, raising concerns about how GPs will be able to effectively put the money to work and how future returns may be impacted as a result.

The overhang in venture capital at the end of 2005 was estimated by Thompson Venture Economics to be less than \$50 billion, down from over \$100 billion at the end of 2002. Buyout funds may hold as much as another \$100 billion overhang. GPs began reducing fund sizes in early 2002; and, in recent fund-raising activities, have generally been targeting smaller funds, some less than half the size of their predecessors. However, limited partners may be contributing to a new type of overhang, through both increased allocations and new entrants to the market that reflects their increased appetites for venture capital and private equity exposure. Hedge funds are also moving into traditional private equity space further adding to the issue of excess capital.

A review of the \$5 billion WSIB private equity overhang by strategy at June 30, 2005, indicates that well over half the unfunded commitments are in the area of corporate finance and that 20 percent is in the venture capital arena.

**Portfolio Allocation by Strategy Based on Unfunded Commitments at June 30, 2005 (\$ millions)**



Thompson Venture Economics reports that for the twelve months ended June 30, 2005, venture capital investments in the U.S. totaled \$21.0 billion in 2,908 deals. Of that total, \$849 million was invested in 152 deals in the Northwest region (defined as Washington, Oregon, Idaho, Montana, and Wyoming). Washington captured 119 of the Northwest deals and \$703 million of the newly invested dollars. During this same time frame, the WSIB GPs invested over \$1.9 billion in private equity including \$18.4 million in Washington-based companies. Over 40 percent of the investment in Washington-based companies represented new investments. The \$18.4 million is over 2.6 percent of the Thompson Venture Economics reported invested dollars in Washington. Based on the Thompson Venture Economics data, venture deals are getting done in Washington.

In the third quarter of 2005, 25 Washington companies raised \$165 million, which is about the same pace as the past four quarters and well below the investment levels of 2000 when the average quarterly total was \$678 million. Notably, the 13 indigenous venture capital funds have raised over \$4 billion since 1999.

The total increases to \$7.5 billion for that time period if national firms that have significant local presence are added. This total does not include local buyout or several small venture funds.

According to the 2005 National Venture Capital Association (NVCA) yearbook, in 2004 Washington venture capitalists invested \$141 million into Washington-based startups and \$317 million to all startups (all deals, all geographies). These numbers were up from 2003 when Washington venture capitalists invested \$76 million in Washington-based startups and \$257 million into all deals. More striking is that Washington-based startups took in \$874 million from all venture capitalists everywhere in 2004, up from \$385 million the year before. This means for every dollar a local venture group put into a deal in 2004, \$2 to \$3 were put into a deal somewhere else. But more importantly, for every dollar invested by local firms, \$4 to \$5 more came in from sources outside the region.

A shortage of investment capital is not an inhibitor to the growth of high-technology companies in Washington State or the U.S. Good deals will attract dollars whether from local players or more remote sources.

## Investments in Washington

The WSIB seeks the best investment opportunities no matter where they might be headquartered. The state of Washington is home to many successful companies and Washington-based investments can be found in all of the WSIB's investment portfolios. The following table reflects a summary of Washington investments in the WSIB portfolio at fiscal years ended June 30, 2004 and 2005.

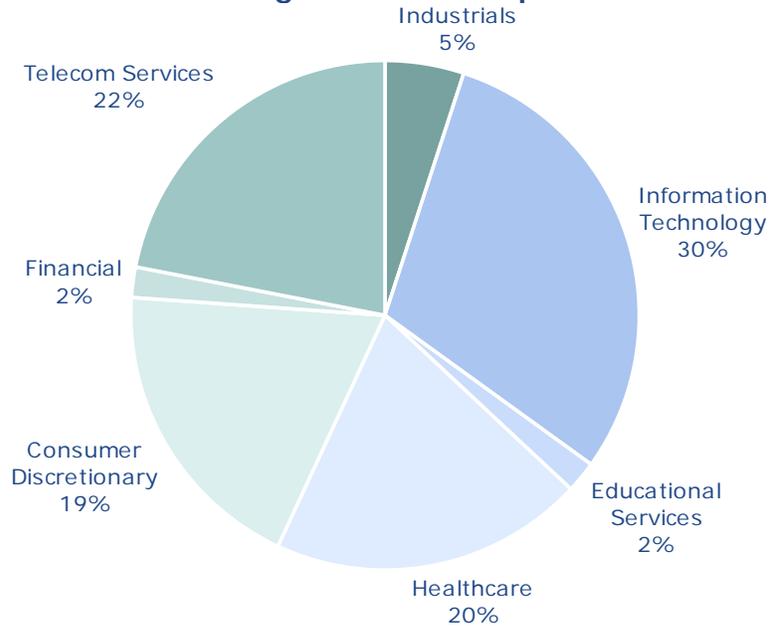
Washington Investments in the WSIB Portfolio (\$ millions)		
Investment Class	Value Fiscal Year ended 6/30/04	Value Fiscal Year ended 6/30/05
Public Equity	\$677.3	\$602.0
Fixed Income	\$196.9	\$148.4
Real Estate	\$428.7	\$448.6
Private Equity	\$61.3	\$66.7
<b>TOTAL</b>	<b>\$1,364.2</b>	<b>\$1,265.7</b>

The WSIB portfolio contains numerous public equity and fixed income investments in Washington-based companies. In the year-over-year comparison, the value of public equities decreased over 11 percent predominantly due to a decline in public market index values in communications and technology, which was primarily attributable to the change in market value of Microsoft. The 25 percent decline in fixed income value was the net result of the portfolio's value of maturing Washington bonds over new bonds added. Several of the WSIB's real estate partners have property investments located in Washington. The 5 percent increase in investment value for real estate in Washington was attributable to new acquisitions and valuation increases, partially offset by dispositions.

The 8.8 percent increase in value year-over-year for private equity was due to the net appreciation in the fair market value for many private companies in the past fiscal year combined with new in-state investments, less \$5 million returned in distributions. As of June 30, 2005, the WSIB had over \$66.7 million invested in Washington-based companies in its private equity portfolio, representing approximately 1.4 percent of the total domestic private equity portfolio value, and including 5 of the top 6 Washington investments for the year ended June 30, 2005. The Washington-based investments are held in 57 different funds by 31 individual GPs, 3 of which are regionally-based.

The following chart depicts the breakout of Washington-based investments in private equity by industry, showing that over 90 percent are concentrated in 4 indigenous industries: Information Technology, Telecom Services, Consumer Discretionary and Healthcare. Three other industries have smaller representation.

**Percent Invested in Washington-based Companies at June 30, 2005**



The WSIB currently has \$16 billion committed to private equity among 93 GPs in 201 partnership funds. More than \$7.3 billion is invested in private equity investments, including \$66.7 million in Washington-based companies. However, nearly a third of the committed total, over \$5 billion, has yet to be called by the GPs. The unfunded commitment represents a significant amount of capital overhang to be invested in the future by current WSIB GPs, many of whom actively review and evaluate investments in Washington State.

## Highlights of 2005 ETI Activity

Following the adoption of the ETI policy in March 2003, a private equity investment officer, Janet Kruzel, was hired on August 1, 2003, to focus on in-state activities. Prior annual ETI reports detailed the initial implementation plans and results for the years 2003 and 2004. Ms. Kruzel has initiated multiple efforts to provide exposure and understanding of the Board's policy in the state and establish contact with the local and regional organizations and networks in order to accomplish successful implementation of the ETI policy. The current outreach included meetings with the Washington Department of Community, Trade and Economic Development and with the U.S. Small Business Administration to seek ways to collaborate efforts to assist entrepreneurs and small businesses.

### Regional Funds

The WSIB is currently invested in three regional firms: Frazier Healthcare Ventures, OVP Venture Partners, and Endeavour Capital. During 2005, staff intensified its assessment of area funds and conducted numerous meetings with over 40 regional funds, concentrated but not limited to those in fund raising mode. The meetings focused on developing strong, in-depth relationships with fund managers and initiating a long, deep due diligence process on the funds and their portfolio companies.

Although many of the fund sizes are smaller than what WSIB usually invests in directly, staff has channeled at least 18 of the regional funds to WSIB's discretionary venture capital managers, INVESCO and Pathway, for investment consideration. INVESCO and Pathway are fiduciaries to the Board and each manages a pool of money to be invested at their discretion in venture capital firms on behalf of the WSIB to provide exposure to the smaller venture capital funds. An additional result of the meetings was that staff was willing and interested, based on the extended knowledge of the firms, in providing access

(through introductions and referrals) for a number of quality area firms to WSIB's peer institutional limited partners and select third parties actively seeking emerging managers. An unplanned benefit of the new relationships was that local area GPs have been receptive to accept staff referrals of at least 17 companies and entrepreneurs that contacted WSIB seeking direct funding.

### Annual GP Deal Flow

The WSIB conducted its third annual survey of the WSIB private equity GPs by sending letters to 64 GPs requesting information about their deal flow review in Washington for the year ended September 30, 2005, including the number of deals done, number passed, and any still in process. The poll was not sent to funds that had completed their investment period or funds that only invest outside the U.S. Over 95 percent of the funds responded. The results continue to show strong, consistent, and active Washington deal interest.

The highlights of the report are:

	2003 Annual Report	2004 Annual Report	2005 Annual Report
<b>Total deals reviewed</b>	567	597	1,223
<b>Number of GPs involved</b>	33	43	46
<b>Deals Passed</b>	508	487	637
<b>Number of GPs involved</b>	6	16	24
<b>Deals in pipeline</b>	30	80	553
<b>Number of GPs involved</b>	9	19	15
<b>Deals done</b>	29	30	33

These responses suggest that Washington continues to earn the interest and access of top-quality GPs, and that interest has remained stable with measured growth over the past three years. The data also suggests that WSIB's GPs were reviewing and doing deals in Washington in the normal course of business before the advent of having to report that activity. Washington is rich with investment opportunity and does not appear to have a problem attracting venture capital and private equity firms to come to the region to look at deals and check out companies. The data also reveals the fact that not all deals get done.

### Regional Networks

Staff made over 42 trips to the Seattle area, several trips to Spokane and Pullman, as well as visits to Richland, Portland, and Bellingham. The WSIB received numerous comments of appreciation for its interest in and willingness to initiate contact across the entire state, especially outside the Seattle area. Staff contributed to several regional networks, and served on the following:

- ❖ Bio21 Funding Subcommittee.
- ❖ WSA Investment Forum Steering Committee.
- ❖ WTC Angel Network Advisory Board.

The WSIB was also represented at the following regional meetings and events:

- ❖ Governor's Life Science Summit.
- ❖ Pacific Northwest Venture Capital Conference (panelist).
- ❖ Spokane Biomedical and Life Science Summit.
- ❖ Frazier Health Care Summit (Arizona).
- ❖ The USA-Philippine International Trade Conference.
- ❖ Alliance of Angels (monthly).
- ❖ Richland Power of Angel Investing.
- ❖ 2004 Northwest Innovation Summit (participant).
- ❖ WSA Industry Achievement Awards.

Each of these presented an opportunity to provide genuine support and expertise to the regional investment environment, broaden the WSIB regional contact base, and enhance and demystify the WSIB image across the entire state. These networks afforded direct contact with academic and research entities, angel groups, and economic development organizations, which in turn resulted in several contacts on potential deal flow. Staff will continue to build and strengthen these relationships over the long term to the benefit of all parties.

#### **“Discussion of Funding Businesses in Washington” Forum**

Economic development is an ongoing concern of government officials and the state’s business community. During past Legislative sessions, proposals mandating the investment of public pension funds in Washington businesses were introduced continuously raising more and more questions about finding practicable and acceptable solutions to improve economic opportunity and growth. To foster the dialog about possible solutions, the WSIB invited various participants in the policy making and investment communities to participate in an open and invigorating discussion of funding sources for start-up and expanding businesses in Washington.

The purpose of the forum was to create a stronger awareness of the many and varied funding sources and services currently available in Washington for entrepreneurs and start-up companies and the appropriate role the WSIB investments represent in that investment environment. The forum sought to improve understanding of a typical user profile of each basic funding source, the expectations and requirements attached to each source, and how the spectrum of funding sources relate to each other (including that no single source fits every need).

Held in Seattle on October 5, 2005, the forum highlighted the dynamics of funding sources and their applications, presented by panelists representing a range of personal, state, federal, angel and venture capital funding sources. One presentation pointed out that venture capital and private equity may represent less than 6 percent of the all sources of capital, stressing the importance of recognizing and utilizing the other capital sources. The forum provided the opportunity to meet and interact with the panelists and learn from entrepreneurs who have navigated the funding process. The goal of this special event was to improve the quality and quantity of the discussions on state action to improve the Washington economy. Over 70 individuals were invited and 41 attended from Legislative offices, government, academia, the regional business community, and WSIB staff. The discussion was excellent and the feedback was positive.

#### **ETI Metrics**

For more than two years, staff has monitored the ETI activities of numerous states and sought metrics that could be applied to the WSIB portfolio review. Staff continued to seek the use of performance measurement for ETIs through websites, written reports, and phone interviews. The review and subsequent updates highlighted that few comprehensive studies have been done on this topic for nearly a decade, although several minor studies are currently underway. It is difficult to narrowly define ETI and no standard methodology has emerged to measure the results of ETI programs. The majority of ETI efforts (excluding programs targeting only social benefits) continue to focus appropriately on investment rate of return as their major or even sole metric. Few investors track other results, and several reported that they specifically do not utilize other metrics to prevent those ancillary measures from complicating or clouding the investment decision process.

Metrics that focus on the health and development of the investment environment provide useful information regarding the WSIB policy. Such metrics spotlight attention on the strengths and weaknesses of the region and may help target specific areas for more effective intervention or make decisions related to continuation or adjustment of the policy. Several measures of the state/regional investment environment have been adapted for use in this report.

## Looking Forward

The implementation efforts will continue to develop during the coming year. The flexibility of the current policy allows staff to respond to needs effectively as they arise. Personal contacts will remain an important means to maintain and solidify valuable relationships with networks and interested parties in the state, and staff interaction with GPs will encourage sustained access and interest in Washington deal flow. The WSIB will continue to work with the Washington networks and individuals in place to:

- ❖ Assist Washington companies to achieve exposure to appropriate potential sources of capital through the WSIB's relationship with both local and national GPs and other funding sources.
- ❖ Expand ways that the WSIB contributes and adds value (other than simply funds) to the regional environment.
- ❖ Enhance the due diligence and relationship building with regional GPs.
- ❖ Continue to improve the WSIB GPs' awareness of and accessibility to potential Washington opportunities.
- ❖ Provide feedback from GPs regarding methods and mechanisms that may help Washington companies become better positioned to seek investment capital.
- ❖ Continue the dialog with WSIB GPs for their feedback and advice on how the WSIB can more effectively exchange information with them on quality investment opportunities in Washington.
- ❖ Continue to monitor ETI policies in a number of other states and refine applicable metrics.

Staff will build on the policy implementation efforts to date to generate long-term results and continue to reflect the WSIB as a strong, interested ally and resource for the Washington investment environment.

## Appendix

### Dollars Invested and Number of Deals July 1, 2004 through June 30, 2005 (\$ million)

#### Washington

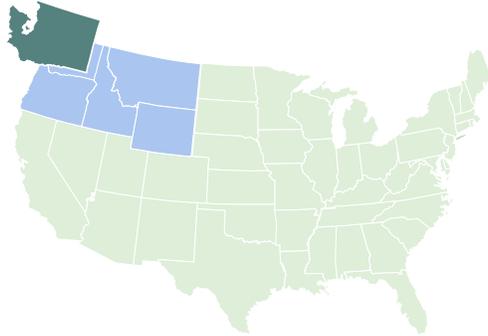
Number of Deals: 119  
Amount: \$703

#### Northwest

Number of Deals: 152  
Amount: \$849

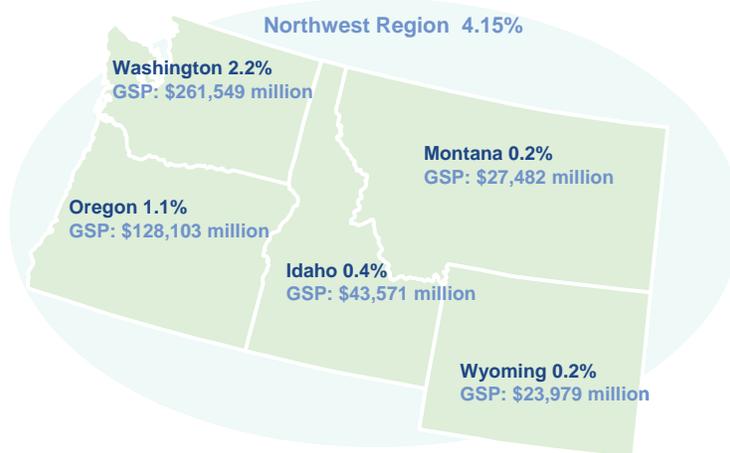
#### U.S.

Number of Deals: 2,908  
Amount: \$21,015



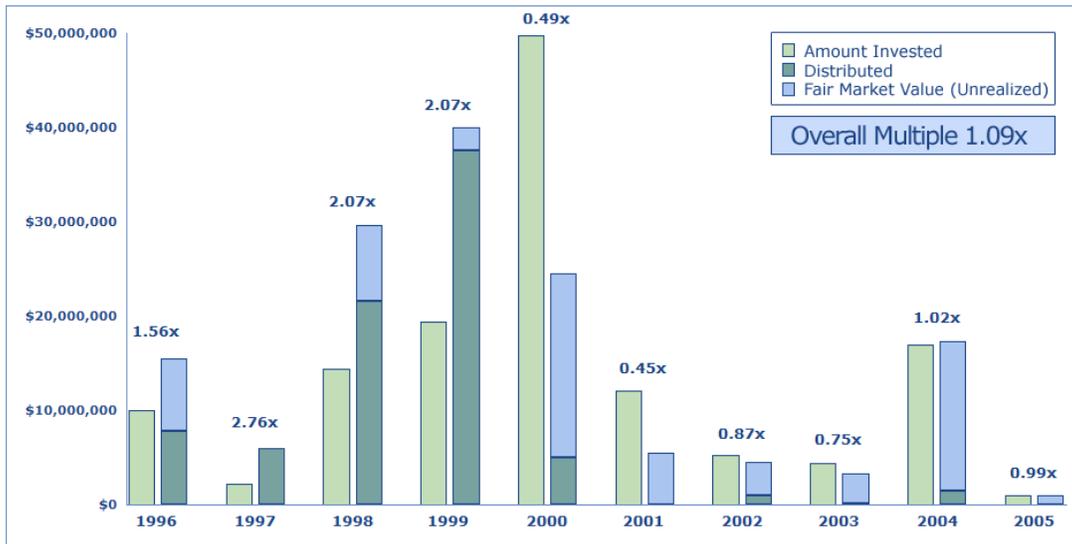
Source: PriceWaterhouseCooper/Venture Economics/NVCA MoneyTree Survey

### 2004 Gross State Product (GSP) as a Percent of U.S. National Gross State Product of \$11.7 trillion



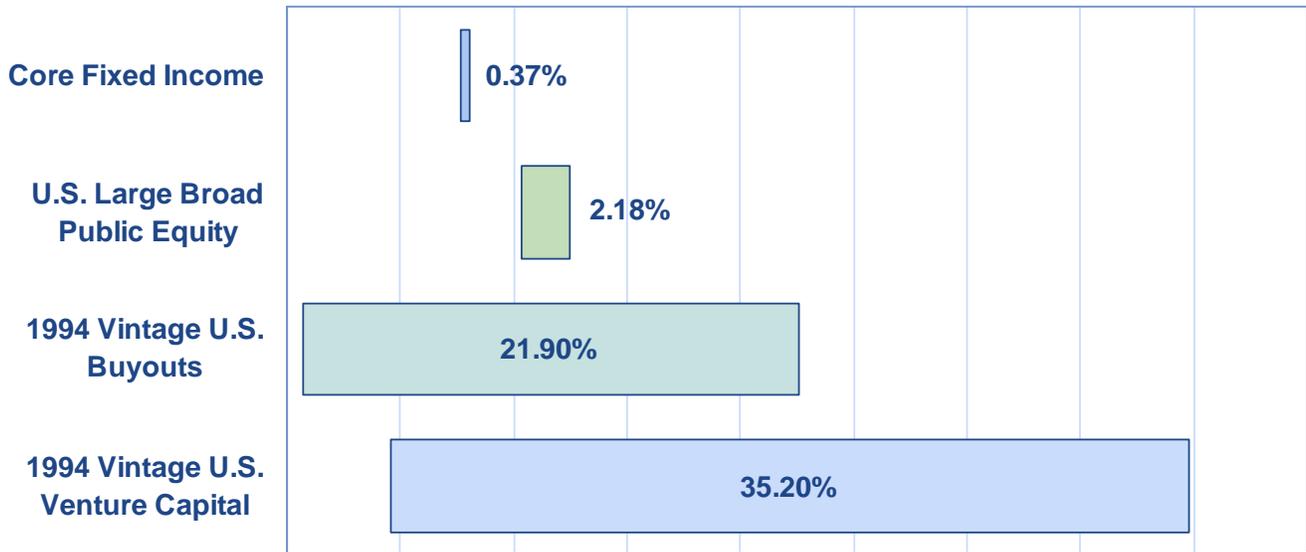
Source: Bureau of Economic Analysis, U.S. Department of Commerce

### Status of Dollars Invested in Washington 1996 through June 30, 2005



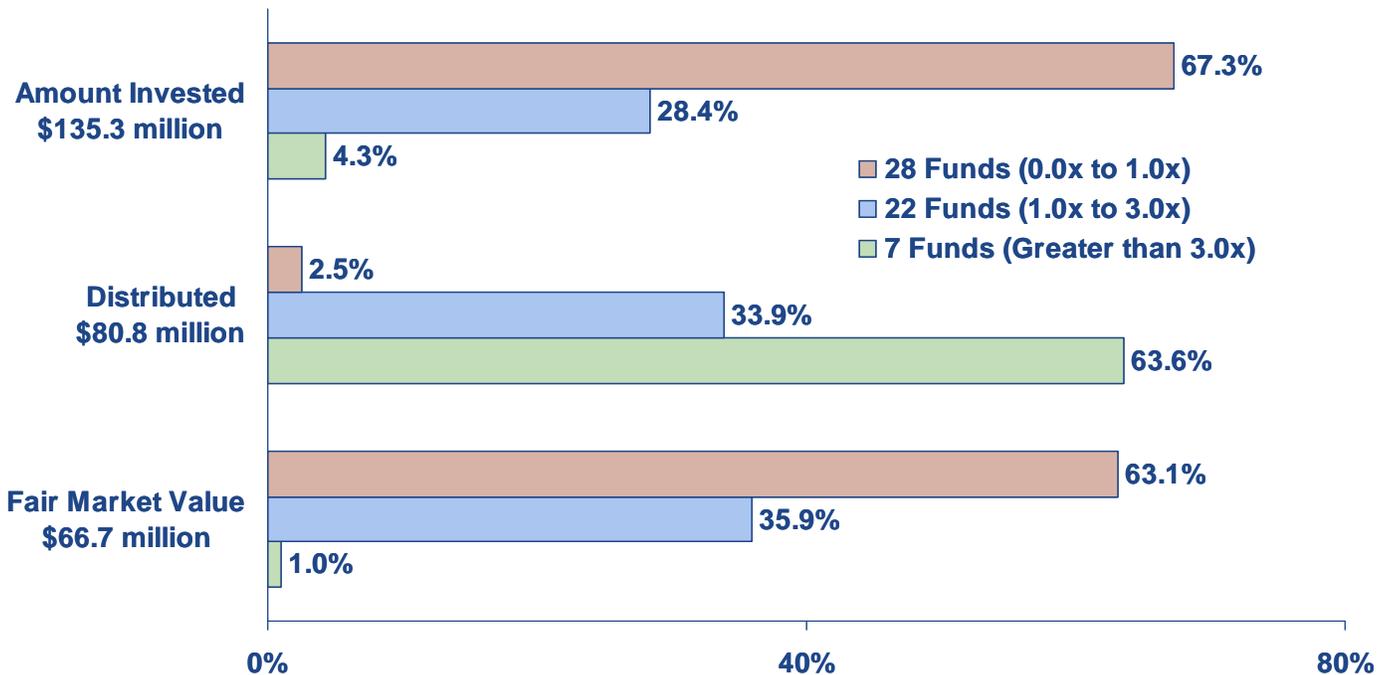
Source: Pacific Corporate Group, LLC

Manager Selection is Critical



Source: Venture Economics

WSIB Investments Made by Our General Partners in Washington From 1992 through June 30, 2005



Out of 57 funds (primarily venture capital), 7 produced 2/3rds of the total distributions

## Meetings with Washington Funds – August 2003 through November 2005

	FIRM		WSIB MEETING (S)	FUND SIZE (MM)
1	<i>ARCH Venture Partners</i>		2	350
2	Battelle Ventures		1	100
3	<b>Blueprint Ventures (Portland partner)</b>		2	150
4	<b>Buerk Dale Victor</b>		9	125
5	Cascadia Capital		2	
6	Chrysalix (BC)		1	
7	<b>Column Group, The</b>		2	500
8	<i>Compass Capital</i>		1	
9	Copan Fund II	a	1	150
10	<b>Divergent Venture Partners</b>		2	100
11	Eastven	a	1	200
12	Encompass Ventures (formerly WSA Ventures)		2	100
13	* <i>Endeavour Capital</i>		6	250
14	Evergreen Pacific Partners		5	225
15	Fluke Venture Partners		1	57
16	Fontis Partners (Ethnic Media)	b	1	150
17	* <i>Frazier Healthcare</i>		5	450
18	Frazier Technology Ventures II		5	150
19	<b>Guide Ventures</b>		3	75
20	<b>Highway 12 (Boise, ID)</b>		2	75
21	<b>IDG</b>		2	100
22	Ignition Partners		2	300
23	<i>Integra Ventures</i>		3	
24	Intel Capital		2	
25	<b>Madrona Venture Fund III</b>		9	150
26	Maveron		1	300
27	<b>Northwest Venture Associates</b>		11	100
28	Northwest Entrepreneur Network		2	
29	N W Location Professionals		1	
30	Obsidian Investment Advisors	c	1	50
31	Orca Bay Partners		1	
32	Oregon Entrepreneur Forum		1	
33	* <b>OVP Venture Partners</b>		6	200
34	<b>Pacific Horizon Venture Partners IV</b>		4	75
35	Paladin Partners		1	
36	<b>Polaris</b>		1	900
27	Quellos Capital		3	
28	Raven Capital		1	
29	Rustic Canyon - 21st Century Energy Fund	b	1	100
40	SeaPoint Ventures		3	
41	Sisu Ventures	d	2	50
42	Staenberg Venture Partners		2	
43	Stratos Biofund		4	40
44	<b>Village Ventures</b>		2	125
45	<b>Voyager Capital</b>		6	215
46	Vulcan Capital		2	
47	WIN Partners		2	
48	WRF		1	
49	WSA Venture Partners (reverted to Encompass)	e	5	100

\* Funds in which WSIB is invested

a Focus on Pacific Northwest

b Associated with Staenberg

c Wellspring (Glenn Gregory)

d Formerly part of Perennial Ventures

e Reverted to Encompass in 2004

**BOLD** = fund raising now*Italics* = pre-fund raising