
Washington State Investment Board Economically Targeted Investment Policy



**2007 Annual Report
December 20, 2007**

Introduction and Summary

The Washington State Investment Board (WSIB or Board) manages \$85.4 billion in assets for 38 separate state retirement and other trust funds as of September 30, 2007. 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 overall performance.

This is the fifth annual report on the WSIB Economically Targeted Investment (ETI) policy. This year's annual poll of the WSIB's private equity General Partners' (GPs') deal flow activity for the year ended September 30, 2007, shows continued strength over all five years. Key findings include the following:

- ❖ 42 GPs looked at 1,139 Washington-based opportunities.
- ❖ 542 deals were still in the pipeline at September 30, 2007.
- ❖ 41 deals were completed.
- ❖ Venture capital and private equity firms continue to look at deals in the region.

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. Over \$1.4 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 \$1.4 billion investment in Washington-based companies represents 2.3 percent of the state's Commingled Trust Fund, while the state's Gross Domestic Product (GDP) is only 0.6 percent of the GDP for the investible universe within which the WSIB invests. More than \$8.7 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 the WSIB's GPs significantly 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 in-state investment activity. The WSIB continues to work with regional partners to access valuable Washington economic development networks, assist Washington companies to achieve exposure to potential sources of capital, and provide feedback regarding educational and investor networking events.

Overview of Policy

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.

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 Board established a staff role 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 this annual report of relative activities to the Board, beneficiaries, Legislature, and Governor.

Investment Environment

Although the WSIB portfolio contains asset classes other than private equity, 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 PwC/NVCA MoneyTree Report based on data from Thomson Financial (MoneyTree Report), U.S. venture capital investing for the first 9 months of 2007 totaled \$22.7 billion, up from \$19.2 billion for the same period in 2006. Remarkably, each of the three consecutive quarters of 2007 was in excess of the \$7 billion mark. Although quarter-to-quarter investment activity has fluctuated, overall it had been fairly stable since the third quarter of 2003. However, in 2007, the cumulative investment level for the year has reached heights not seen since mid-2001.

Consistent with historical percentages, the Life Sciences (Biotechnology and Medical Devices industries together) continued to earn strong interest, capturing \$1.9 billion or 27 percent of all venture investing in the third quarter of 2007. Software narrowly edged out Biotechnology as the number one industry sector for the quarter and, although down slightly from previous quarters, still accounts for 15 percent of total dollars and 21 percent of all deals. Internet-specific companies also received \$1.1 billion or 15 percent of total dollars and 22 percent of all deals, consistently attracting investments of more than \$1 billion each quarter for 4 of the last 5 quarters. (Internet-specific is now a discrete classification assigned to a company with a business model fundamentally dependent on the Internet, regardless of the primary industry category.) Both Telecommunications and Semiconductors drew more dollars but fewer deals in the third quarter.

Venture capitalists are apparently diversifying across various industries by increasing investments in innovative new industry sectors such as alternative energy. Cleantech (comprised of alternative energy, pollution and recycling, power supplies, and conservation) is an emerging sector that crosses traditional MoneyTree sectors; it produced three of the top five deals in the quarter, including a \$100 million deal--one of the largest deals ever for the sector.

For the third quarter of 2007, venture capital investment in expansion stage companies increased 16 percent in dollars and accounted for 33 percent of the deals; first-time financings continued at strong levels with nearly half the dollars going to seed/early stage deals, apparently reflecting optimism within the industry and greater confidence in the potential opportunities represented in young companies. Seed/early stage funding declined 15 percent in dollars and 6 percent in deals; likewise, later stage declined slightly in dollars and increased 5 percent in number of deals.

Private equity fundraising activity remained robust with 220 venture capital funds raising nearly \$20.7 billion, and 123 buyout and mezzanine funds raising over \$107.6 billion during the first three quarters of 2007. Fundraising receded somewhat in the third quarter as firms shifted to deploying dollars recently raised. According to the National Venture Capital Association, balanced venture capital funds were the most active in the third quarter with 16 funds raising \$3.4 billion or 56 percent of the third quarter amount. Follow-on venture capital funds continued to be the dominant fundraisers with 51 funds

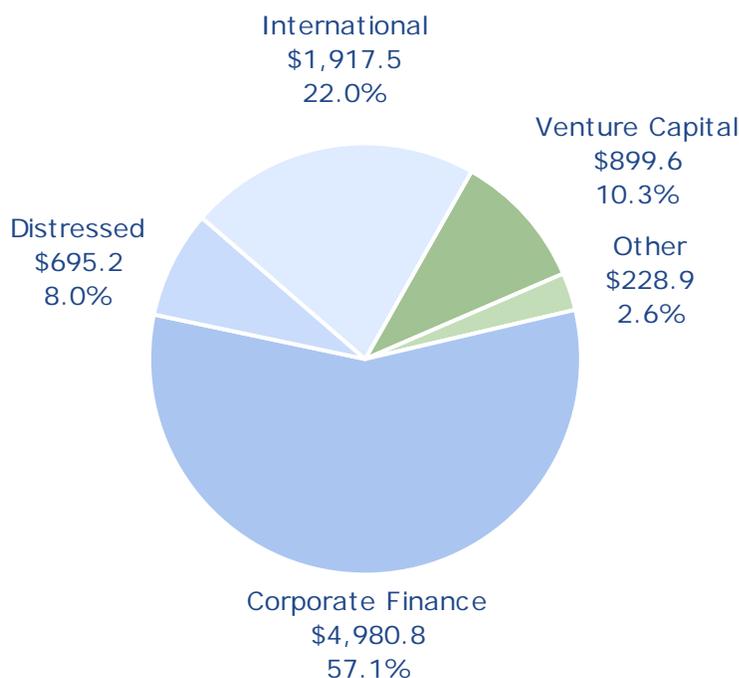
accounting for 91 percent of the amount raised in the quarter. Only eight new funds were raised in the third quarter, the smallest number of new funds since mid-1995. The ratio of follow-on funds raised compared to first time funds was more than six-to-one.

Following several recent very heavy fundraising years, one continuing concern 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.

Venture capital GPs began reducing fund sizes in early 2002, and many have generally been targeting smaller funds in recent fund-raising activities, some nearly half the size of their predecessors. Although numerous private equity GPs have raised ever larger funds in recent years, active deal closures and increased deal sizes have helped reduce overhang to an estimated 20 percent, its lowest level since 1990. Limited partners may contribute to overhang through both increased allocations and new entrants to the market that reflect their increased appetites for venture capital and private equity exposure. Hedge funds also continue to add to the issue of excess capital as they edge further into what was traditional private equity space.

A review of the \$8.7 billion WSIB private equity overhang by strategy at June 30, 2007, points out that more than half the unfunded commitments are in the area of corporate finance and that over 10 percent are in the venture capital arena.

Portfolio Allocation by Strategy Based on Unfunded Commitments at June 30, 2007 (\$ millions)



The MoneyTree Report states that for the 12 months ended June 30, 2007, venture capital investments in the U.S. totaled \$27.8 billion in 3,659 deals. Of that total, \$1,334 million was invested in 189 deals in the Northwest region (defined as Washington, Oregon, Idaho, Montana, and Wyoming). Washington captured 146 of the Northwest deals and \$1,082 million of the newly invested dollars. During this same time frame, the WSIB GPs invested nearly \$3.3 billion in private equity including \$22.9 million in Washington--based companies. The \$22.9 million is over 2.1 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 2007, 38 Washington companies raised \$235.6 million, which is the lowest quarter of the last 12 and well below the investment levels of 2000 when the average quarterly total was

\$678 million. Notably, the 20 indigenous venture capital funds have raised over \$6 billion since 1999. The total increases to over \$13 billion for that time period if national firms that have significant local presence are added. This total does not include local buyout or several closed private funds.

Much of the discussion on Washington-based investments focuses on the dollars WSIB has invested in Washington through its GPs. While this is an important amount, it may also be useful to expand the perspective on the funding of a Washington investment to include the total amount the WSIB GPs invested in a Washington deal and, further, to examine the total funding round for a Washington deal that includes the non-WSIB GPs. The power of this multiple can be observed through a real example of the investment round for a Washington-based company that received money from four GPs, one of which is a WSIB GP. The total investment round for the company is \$55 million; two non-Washington based GPs invested \$36 million; one Washington-based GP invested \$9 million; the WSIB Washington-based GP invested \$10 million or 18 percent of that round; and the WSIB portion is reported as \$2.2 million, or approximately 4 percent of the total funding.

Focusing on only the \$2.2 million attributed directly to WSIB in the example overlooks the significance of nearly \$53 million invested in a Washington-based company by other sources from both in and outside the state. The amount reported for private equity invested in Washington has grown by nearly 11 percent from \$95.2 million at June 30, 2006, to \$105.4 million at June 30, 2007. The true impact of that amount on the Washington economy is substantially enhanced by the above described multiple effect of including the total amount of the WSIB GPs' investments and the addition of non-WSIB GPs' investments.

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 continue to 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, 2005, 2006, and 2007.

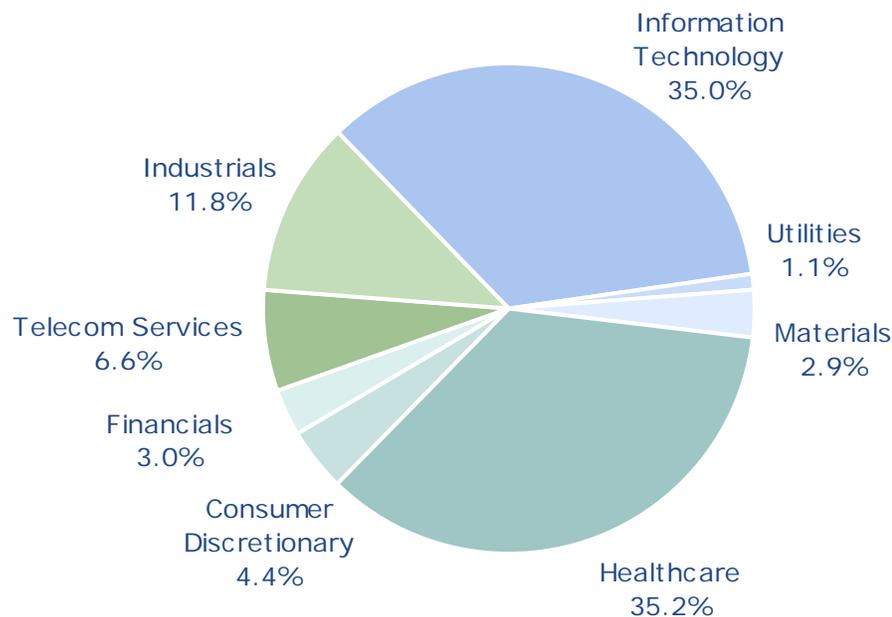
Washington Investments in the WSIB Portfolio (\$ millions)				
Investment Class	Value Fiscal Year Ended 6/30/04	Value Fiscal Year Ended 6/30/05	Value Fiscal Year Ended 6/30/06	Value Fiscal Year Ended 6/30/07
Public Equity	\$677.3	\$602.0	\$474.2	\$575.0
Fixed Income	\$196.9	\$148.4	\$85.8	\$126.6
Real Estate	\$428.7	\$448.6	\$615.7	\$633.6
Private Equity	\$61.3	\$66.7	\$95.2	\$105.4
TOTAL	\$1,364.2	\$1,265.7	\$1,270.9	\$1,440.6

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 increased 21.3 percent due mostly to the increase in monies invested in public equities as well as a slight boost from increased exposure to profitable and well run Washington-based companies. On a comparative basis, the percentage of Washington investments to the net asset value in public equities for 2007 increased by 2.9 percent, regaining most of the exposure previously lost from 2005 to 2006. The 47.6 percent increase in fixed income value was the net result of the portfolio's increased exposure to several Washington-based companies such as Costco and Puget Energy. The 2.9 percent increase in investment value for real estate in Washington was attributable to appreciation and new acquisitions.

The 10.7 percent increase in value year-over-year for private equity was due to \$22.9 million new in-state investments combined with \$10.6 million net appreciation in the fair market value for various private companies in the past fiscal year, less over \$23.2 million returned in distributions. As of June 30, 2007, the WSIB had nearly \$105.4 million invested in Washington-based companies in its private equity portfolio, representing approximately 1.1 percent of the total domestic private equity portfolio value. The Washington-based investments are held in 82 different funds by 46 individual GPs, 4 of which are regionally based.

The following chart depicts the breakout of Washington-based investments in private equity by industry, showing over 80 percent are diversified across three indigenous industries: Healthcare, Information Technology, and Industrials. Five other industries have smaller representation.

Percent Invested in Washington-Based Companies at June 30, 2007



At June 30, 2007, the WSIB's private equity portfolio, invested with 106 GPs in 252 partnership funds, was valued at more than \$12.1 billion. An additional \$8.7 billion had yet to be called by the GPs. The unfunded commitment represents a significant amount of capital to be invested in the future by current WSIB GPs, many of whom actively review and evaluate investments in Washington State.

Highlights of 2007 ETI Activity

WSIB staff have 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.

Regional Funds

The WSIB is currently invested in four regional firms: Endeavour Capital, Frazier Healthcare Ventures, OVP Venture Partners, and Polaris Venture Partners. During 2007, staff continued its assessment of area funds and conducted numerous meetings with regional funds, concentrated but not limited to those in fund raising mode. The meetings with nearly 70 firms in the past 4 years have 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.

Staff has performed due diligence on each regional fund raising capital, even though most of the fund sizes are smaller than those WSIB usually invests in directly. Staff has channeled a number of regional funds to Pathway, WSIB's discretionary venture capital manager, for investment consideration. Pathway is a fiduciary to the Board and 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. As a result of the extended knowledge of the firms, staff also provided access (through introductions and referrals) for several quality area firms to WSIB's peer institutional limited partners and select third parties actively seeking emerging managers. Regional GPs have continued to welcome staff referrals of several companies and entrepreneurs that contacted WSIB seeking direct funding.

Annual GP Deal Flow

The WSIB conducted its fifth annual survey of the WSIB private equity GPs by sending letters to 54 GPs requesting information about their deal flow review in Washington for the year ended September 30, 2007, 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 87 percent of the GPs responded. The results continue to show strong, consistent, and active Washington deal interest. The table below highlights the results.

	2003 Annual Report	2004 Annual Report	2005 Annual Report	2006 Annual Report	2007 Annual Report
Number of GPs involved	33 of 51	43 of 56	46 of 62	50 of 66	42 of 54
Total deals reviewed	567	597	1,223	1,367	1,139
Deals not pursued	508	487	637	823	556
Number of GPs involved	6	16	24	34	28
Deals in pipeline	30	80	553	493	542
Number of GPs involved	9	19	15	20	17
Deals done	29	30	33	51	41

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 4 years. The data also suggests that WSIB's GPs review and do deals in Washington in the normal course of their business, aside from the advent of reporting 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 check out companies, look at deals, and fund their choice of opportunities. The data is also a reminder that not all deals get done.

Regional Networks

Staff made over 24 trips to the Seattle area, contributed to several regional networks, and served on the WSA Investment Forum Steering Committee.

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

- ❖ 10th Annual University of Washington Business Plan Competition (judge)
- ❖ OVP Venture Partners Technology Summit
- ❖ WBBA Invest Northwest
- ❖ Regional Investors Roundtable meetings
- ❖ Cleantech Investing in the Pacific Northwest Conference
- ❖ Governor's Life Science Summit

Each of these presented an opportunity to participate and hopefully contribute 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, family offices, and economic development organizations. Staff will continue to build and strengthen these relationships over the long term to the benefit of all parties.

ETI Metrics

For more than 4 years, staff has monitored the ETI activities of numerous states and sought metrics that might 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. 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 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.

In 2006, staff assumed a leadership role in the Institutional Limited Partners Association's (ILPA) targeted programs project, which focuses on researching and developing industry best practices among global institutional private equity investors. Initial research is completed and the report, including several case studies, is being prepared for presentation at the Spring ILPA Conference. Research will continue in order to provide periodic updates to the report as presented.

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 individuals and networks 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, 2006 through June 30, 2007 (\$ million)

Washington

Number of Deals: 146

Amount: \$1,082

Northwest

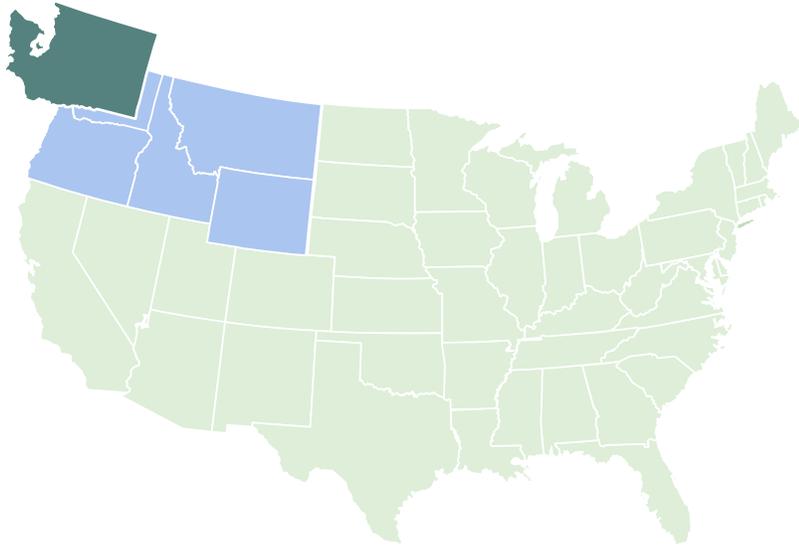
Number of Deals: 189

Amount: \$1,334

U.S.

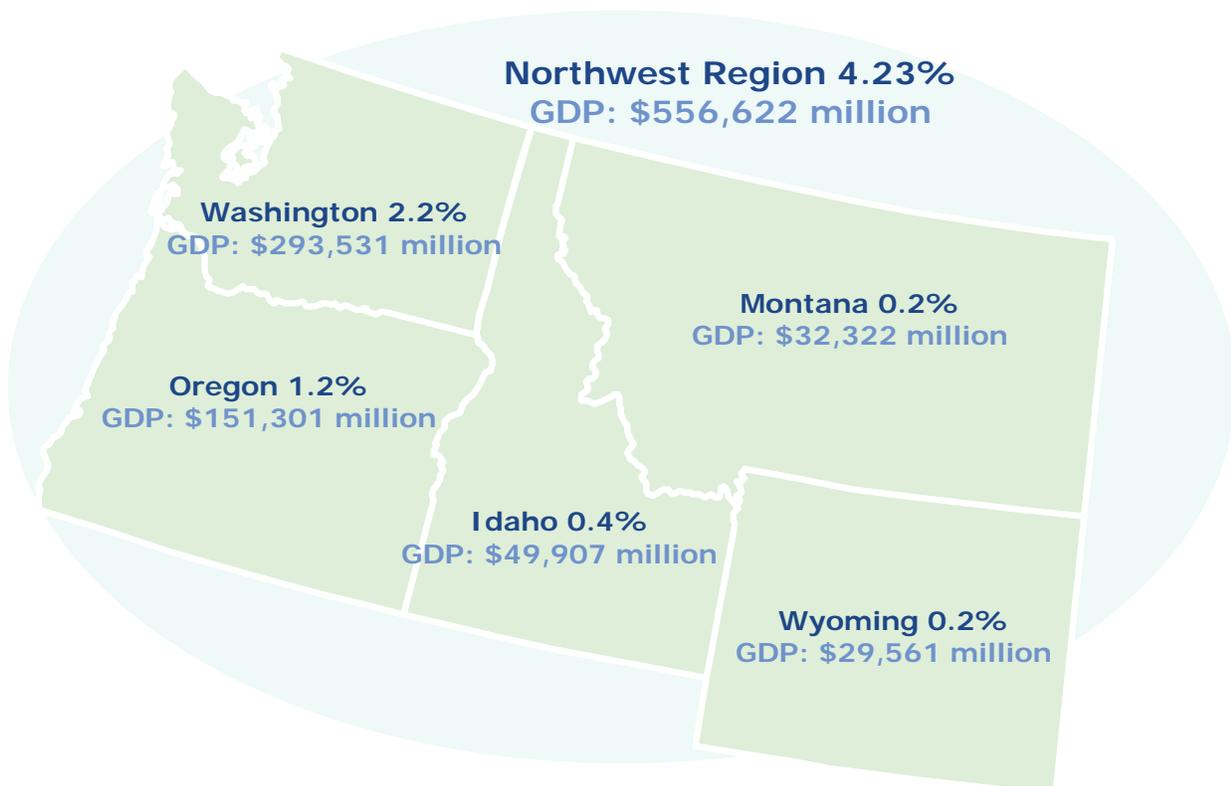
Number of Deals: 3,659

Amount: \$27,779



Source: PwC/NVCA MoneyTree Report based on data from Thomson Financial

2006 Gross Domestic Product (GDP) as a Percent of U.S. National GDP of \$13.1 trillion



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

Meetings with Washington Funds – August 2003 through November 2007

FIRM	WSIB MEETING(S)		FIRM	WSIB MEETING(S)	
1 Altitude Life Science Ventures	1/13/06	1	36 <i>Integra Ventures</i>	2/21/07	5
2 Amerivon Equity Partners	3/1/06	1	37 Intel Capital	7/23/05	2
3 Arcadia Ventures (Campbell & Miner)	3/30/06	1	38 Intellectual Ventures	3/2/07	2
4 ARCH Venture Partners	12/8/06	6	39 Keiretsu Forum (Todd Dean)	2/1/07	3
5 Battelle Ventures		1	40 <i>Madrona Venture Fund III</i>	10/31/07	12
6 Blue Point Capital Partners	4/23/07	2	41 Maveron	3/23/07	2
7 Blueprint Ventures (Portland partner)	8/8/05	2	42 Northern Lights Ventures	1/25/07	1
8 Buerk Dale Victor	4/26/07	17	43 Northwest Venture Associates	6/2/06	15
9 Cascadia Capital	5/16/05	2	44 Northwest Entrepreneur Network	7/26/06	4
10 Cascadia Partners	12/2/05	1	45 N W Location Professionals		1
11 Chrysalix (BC)	3/29/05	1	46 Obsidian Investment Advisors		1
12 Column Group, The	3/21/07	3	47 Orca Bay Partners		1
13 Community Capital Management	6/27/07	1	48 Oregon Entrepreneur Forum	4/21/05	1
14 Compass Capital	6/6/05	1	49 OVP Venture Partners	5/7/07	11
15 Copan Fund II		1	50 Pacific Horizon Venture Partners IV		4
16 Delta Plant Technology	6/6/07	4	51 Paladin Partners		1
17 Divergent Venture Partners	2/22/06	3	52 Polaris	11/2/05	1
18 Eastven		1	53 Quellos Capital	9/12/05	3
19 Elliott Bay Capital	2/2/07	1	54 Raven Capital	3/24/05	1
20 Encompass Ventures (formerly WSA Ventures)		2	55 Riverlake	10/2/07	1
21 Endeavour Capital	4/18/07	9	56 <i>Rustic Canyon</i>	9/7/07	2
22 Equilibrium	9/4/07	1	57 SeaPoint Ventures		3
23 <i>Evergreen Pacific Partners</i>	10/31/07	7	58 Sisu Ventures		2
24 <i>Fluke Venture Partners</i>	4/30/07	4	59 Smart Starters	9/25/07	1
25 Fontis Partners (Ethnic Media)		1	60 Staenberg Venture Partners		2
26 Frazier Healthcare	6/2/06	6	61 Stratos Biofund		4
27 Frazier Technology Ventures	2/8/07	7	62 Trilogy Partners	6/2/06	1
28 Fulton Ventures (Dr. Samir Master)	10/23/07	3	63 Unnamed	10/7/07	2
29 Guide Ventures		3	64 Village Ventures		2
30 Highbury Pacific Capital	6/19/07	1	65 Voyager Capital	3/7/07	8
31 Highway 12 (Boise, ID)		2	66 Vulcan Capital	4/25/07	3
32 IDG	6/2/05	2	67 WIN Partners	3/24/05	2
33 Ignition Partners	5/15/07	4	68 WRF	3/21/07	2
34 Ignition Growth Capital	5/15/07	1	69 WSA Venture Partners (reverted to Encompass)		5
35 Ignition China	5/15/07	1	70 Zefram LLC	9/4/07	2