
Washington State Investment Board Economically Targeted Investment Policy



**2008 Annual Report
December 18, 2008**

Introduction and Summary

The Washington State Investment Board (WSIB or Board) manages \$74.5 billion in assets for 38 separate state retirement and other trust funds as of September 30, 2008. 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, tangible assets, and private equity to help control risk and ensure stronger overall performance.

This is the sixth annual report on the WSIB Economically Targeted Investments (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, 2008, shows continued strength over all 6 years. Key findings include the following:

- ❖ 42 GPs looked at 1,662 Washington-based opportunities.
- ❖ 913 deals were still in the pipeline at September 30, 2008.
- ❖ 40 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 \$1.3 billion in value is currently held in the WSIB investment portfolio in Washington-based investments through its public equity, fixed income, real assets, 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 2.12 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. Nearly \$8.4 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 and assist Washington companies to achieve exposure to potential sources of capital.

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 possible 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 generally 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 2008 totaled \$22.6 billion, down only slightly from \$22.7 billion for the same period in 2007. Remarkably, each of the three consecutive quarters of 2008 was in excess of the \$7 billion mark. Although quarter-to-quarter investment activity has fluctuated, overall it had been fairly stable and trending upward since the third quarter of 2003. Despite the turmoil in the global financial markets, venture capital investing in 2008 so far has remained within historical norms. The impact of the disruption is expected to become evident as decreased investment over the next several quarters.

Consistent with historical percentages, the Life Sciences (Biotechnology and Medical Devices industries together) continued to earn strong interest, capturing \$2.2 billion or 31 percent of all investment dollars and 23 percent of all deals in the third quarter of 2008. Biotech narrowly edged out Software as the top industry sector in terms of dollars in the third quarter with \$1.35 billion invested compared to \$1.34 billion invested in Software companies. However, Software remained the top industry for the quarter by number of deals with 24 percent of the deals done, surpassing Biotechnology with less than 13 percent of deals.

Cleantech (comprised of alternative energy, pollution and recycling, power supplies, and conservation) is an emerging sector that crosses traditional MoneyTree sectors; it attracted \$1 billion for 73 deals and produced 4 of the top 10 deals in the quarter, including the top 2 deals. Venture capitalists are apparently diversifying across various industries by increasing investments in innovative new industry sectors such as alternative energy. Internet-specific companies received \$1.1 billion or 15 percent of total dollars and 21 percent of all deals, consistently

attracting investments of more than \$1 billion each quarter for 9 consecutive 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.) Industrial/Energy investment activity was essentially flat in the quarter, and Telecommunications sunk to its lowest investment level since third quarter 1997.

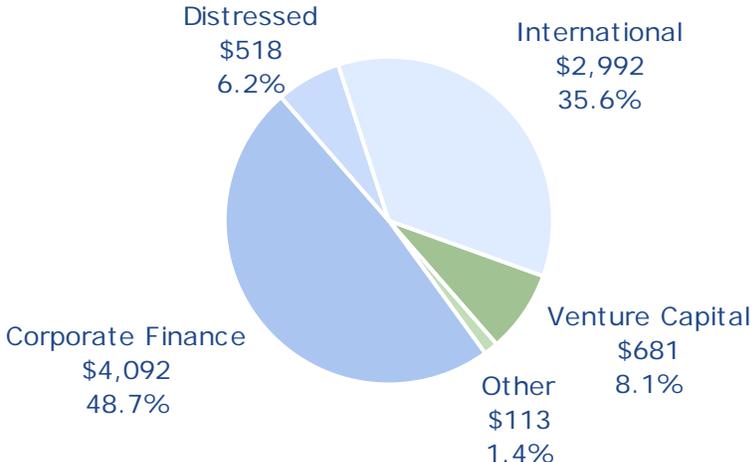
For the third quarter of 2008, first-time financings declined in both dollars and number of deals to the lowest levels since the first half of 2004. Seed/Early stage companies continued to receive over half the dollars and nearly three-fourths of the first-time financings, apparently reflecting some optimism within the industry and greater interest in the potential opportunities represented in young companies. Seed/Early stage funding accounted for 23 percent in dollars and 39 percent of total deal volume in the quarter. Expansion stage deals received 29 percent of the deals, the lowest level for this stage in the history of the MoneyTree survey.

Private equity fundraising activity remained robust with 188 buyout and mezzanine funds raising over \$162.4 billion and 201 venture capital funds raising over \$24.3 billion during the first three quarters of 2008. The number of buyout and mezzanine funds being raised decreased from 192 to 188 over the same period last year; however, the total dollars increased nearly 17 percent. Although the number of venture firms fundraising declined over 17 percent, the capital raised increased nearly 2 percent over the same period last year, reflecting the already anticipated trend of fewer firms raising larger funds. The National Venture Capital Association (NVCA) expects many firms with proven track records will be focused on investing in longer term, capital intensive industries such as life sciences and clean technology. Follow-on venture capital funds continued to be the dominant fundraisers; the ratio of follow-on funds raised compared to first time funds was nearly four-to-one. Only ten new funds were raised in each of the first and third quarters, the smallest number of new funds per quarter since mid-1995.

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. Recent turmoil in the financial markets has heightened this concern as many firms find debt is more difficult and more costly to secure, and a larger portion of some deals must be invested as equity. Many GPs must also commit additional time and unplanned follow-on financings to existing portfolio companies that have been impacted by market disruptions and a closed IPO window, channeling resources away from new deals and lengthening the time investments are held. These strategic changes raise concerns about how GPs will effectively put the money to work and how future returns may be impacted as a result.

A review of the \$8.4 billion WSIB private equity overhang by strategy at June 30, 2008, points out that nearly half the unfunded commitments are in the area of corporate finance, more than one third are in international strategies, and less than 10 percent are in the venture capital arena.

Portfolio Allocation by Strategy Based on Unfunded Commitments at June 30, 2008 (\$ millions)



The MoneyTree Report states that for the 12 months ended June 30, 2008, venture capital investments in the U.S. totaled \$31.4 billion in 4,055 deals. Of that total, \$1.6 billion was invested in 227 deals in the Northwest region (defined as Washington, Oregon, Idaho, Montana, and Wyoming). Washington captured 182 of the Northwest deals and \$1.4 billion of the newly invested dollars. During this same time frame, the WSIB GPs invested nearly \$4.6 billion in private equity including \$60.1 million in Washington-based companies. The \$60.1 million is over 4.4 percent of the Thompson Venture Economics reported invested dollars in Washington. Based on the Thompson Venture Economics data, deals are getting done in Washington.

In the third quarter of 2008, 36 Washington companies raised \$226.5 million, which is the lowest quarter of the last 15 and well below the investment levels of 2000 when the average quarterly total was \$678 million. Notably, the 26 indigenous venture capital funds have raised nearly \$7.4 billion since 1999. The total increases to nearly \$17 billion for that time period if 6 national firms that have significant local presence are added. This total does not include local buyout funds 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 also 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 several GPs, one of which is a WSIB GP. The total investment for the company was \$49 million; \$19.3 million was invested by investors from outside the region; \$17.8 million was from a non-WSIB Washington-based investor; and \$11.9 million (more than 24 percent of that round) was from the WSIB's Washington-based GP. The WSIB portion is reported as \$1.88 million, or approximately 4 percent of the total funding.

Focusing on only the \$1.88 million attributed directly to WSIB in the example overlooks the significance of more than \$47 million total 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 37 percent from \$105.4 million at June 30, 2007, to \$144.24 million at June 30, 2008. 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 additional recognition of non-WSIB GPs' investments.

According to the NVCA, 78 percent of venture capital investment into Washington companies comes from out of state including non-U.S. sources. 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 each fiscal year ended June 30 for the years 2004 through 2008.

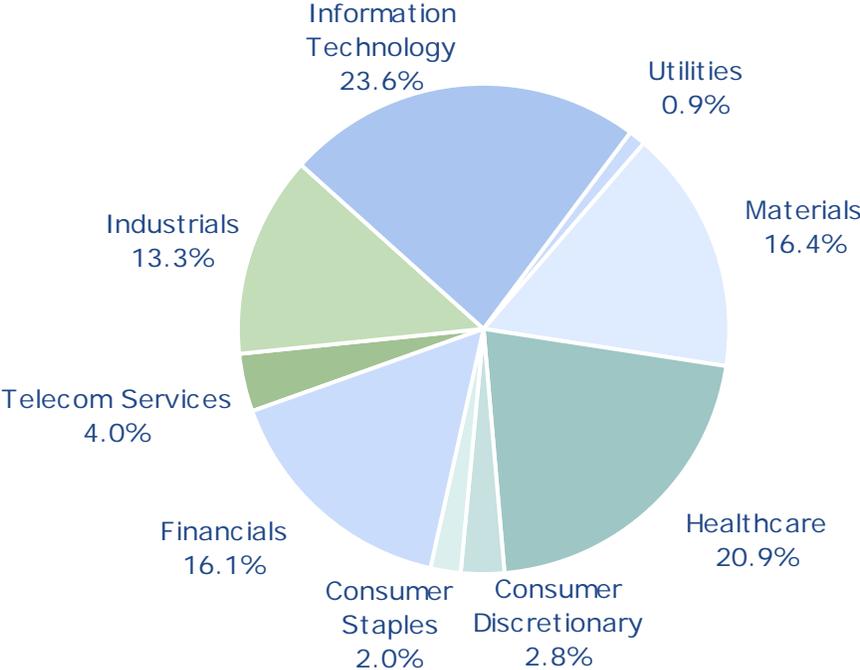
Washington Investments in the WSIB Portfolio					
Investment Class	Value Fiscal Year Ended June 30 (\$millions)				
	2004	2005	2006	2007	2008
Public Equity	\$677.3	\$602.0	\$474.2	\$575.0	\$395.3
Fixed Income	\$196.9	\$148.4	\$85.8	\$126.6	\$121.5
Real Estate	\$428.7	\$448.6	\$615.7	\$633.6	\$656.3
Private Equity	\$61.3	\$66.7	\$95.2	\$105.4	\$144.2
TOTAL	\$1,364.2	\$1,265.7	\$1,270.9	\$1,440.6	\$1,317.3

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 31.3 percent, although the investment opportunity set within Washington remained stable. The decreased value was due mostly to the downward movement of the market but also included the results of asset allocation shifts. The 4 percent decrease in fixed income value was the result of a bond maturity. The 3.7 percent increase in investment value for real estate in Washington was attributable to appreciation, net acquisitions/dispositions, and financings.

The 36.8 percent increase in value year-over-year for private equity was due to \$60.1 million new in-state investments combined with \$13 million net depreciation in the fair market value for various private companies in the past fiscal year, less \$8.3 million returned in distributions. As of June 30, 2008, the WSIB had more than \$144.2 million invested in Washington-based companies in its private equity portfolio, representing approximately 1.4 percent of the total domestic private equity portfolio value. The Washington-based investments are held in 83 different funds by 44 individual GPs, 5 of which are regionally based.

This report is based on June 30, 2008 data, the most current non-publicly traded data available; and in the subsequent quarters of 2008, many of WSIB's investments have been negatively

Percent Invested in Washington-Based Companies at June 30, 2008



impacted by the disruptions in the market. In particular, investments in a large Washington financial institution were part of WSIB's public and private markets assets and will result in a significant decline in the fair market value of Washington-based investments in the WSIB portfolio. For private equity, the decline will amount to approximately \$20 million, or one-third of the new in-state investments included in the chart above. The full impact on investments in Washington-based companies will continue to develop over future quarters.

The following chart depicts the breakout of Washington-based investments in private equity by industry, showing over 90 percent are diversified across five indigenous industries: Information Technology, Healthcare, Materials, Financials, and Industrials. Four other industries have smaller representation.

At June 30, 2008, the WSIB's private equity portfolio, invested with 109 GPs in 262 partnership funds, was valued at nearly \$13.2 billion. An additional \$8.4 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 2008 ETI Activity

WSIB staff have sustained program 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 five regional firms: Endeavour Capital, Evergreen Pacific Partners, Frazier Healthcare Ventures, OVP Venture Partners, and Polaris Venture Partners. During 2008, 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 80 firms in the past 5 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. As a result of this extended knowledge of the firms, staff has willingly channeled a number of quality regional firms (through introductions and referrals) to WSIB's peer institutional limited partners and select third parties actively seeking emerging managers for investment consideration. Regional GPs have continued to welcome staff referrals of a number of companies and entrepreneurs that contacted WSIB seeking direct funding.

Annual GP Deal Flow

The WSIB conducted its sixth annual survey of the WSIB private equity GPs by sending letters to 55 GPs requesting information about their deal flow review in Washington for the year ended September 30, 2008, 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 96 percent of the GPs responded. The results continue to show strong, consistent, and active Washington deal interest. The table below highlights the results.

	Annual Report for the Year:					
	2003	2004	2005	2006	2007	2008
Number of GPs involved	33 of 51	43 of 56	46 of 62	50 of 66	42 of 54	42 of 55
Total deals reviewed	567	597	1,223	1,367	1,139	1,662
Deals not pursued	508	487	637	823	556	709
Number of GPs involved	6	16	24	34	28	23
Deals in pipeline	30	80	553	493	542	913
Number of GPs involved	9	19	15	20	17	19
Deals done	29	30	33	51	41	40

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 6 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 an important reminder that not all deals get done.

Regional Networks

Staff made over 20 trips to the Seattle area and one to Portland, 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:

- ❖ Governor's Life Science Summit
- ❖ WBBA Invest Northwest
- ❖ Washington Technology Industry Association (WTIA) Investment Forum
- ❖ OVP Venture Partners Technology Summit
- ❖ 11th Annual University of Washington Business Plan Competition (judge)
- ❖ TechAlliance 2008 State of Technology
- ❖ Cleantech Investing in the Pacific Northwest Conference
- ❖ Regional Investors Roundtable meeting

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. 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 5 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 focused on researching and developing industry best practices among global institutional private equity investors. The report, including several case studies, was presented at the Fall 2008 ILPA Conference. Research continues in order to provide periodic updates to the report as presented. The report content was both drawn from and applied to the WSIB ETI policy to verify optimal policy implementation.

Looking Forward

The flexibility of the WSIB policy allows staff to respond to needs effectively as they arise. Personal contacts remain an important means to maintain and solidify valuable relationships with networks and interested parties in the state. Staff interaction with GPs is focused on encouraging

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 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 GP feedback that may help Washington companies become better positioned to seek investment capital.
- ❖ Continue the dialog with WSIB GPs to help WSIB 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, 2007 through June 30, 2008 (\$ million)

Washington

Number of Deals: 182

Amount: \$1,357.7

Northwest

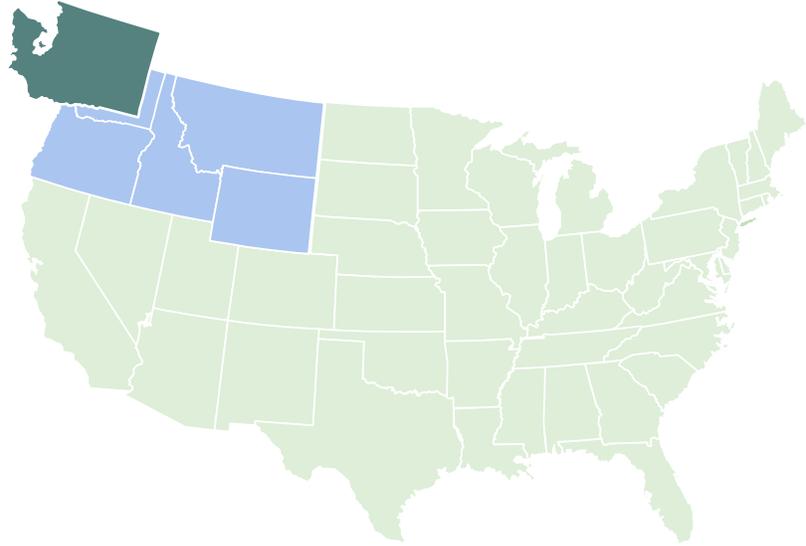
Number of Deals: 227

Amount: \$1,615.6

U.S.

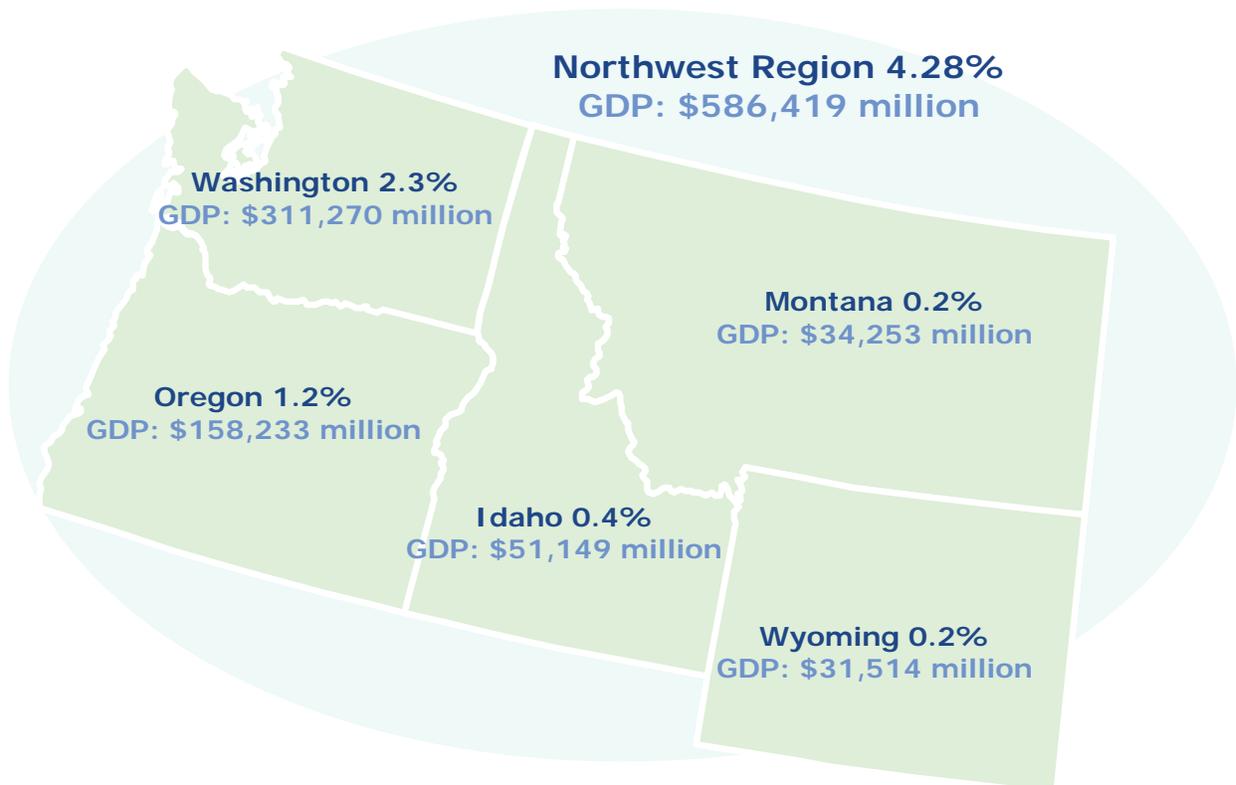
Number of Deals: 4,055

Amount: \$31,409.8



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

2007 Gross Domestic Product (GDP) as a Percent of U.S. National GDP of \$13.7 trillion



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

Meetings with Washington Funds and Related Organizations – August 2003 through November 2008

FIRM	* WSIB MEETING(S)		FIRM	* WSIB MEETING(S)	
1 Altitude Life Science Ventures	1/13/06	1	40 Integra Ventures	9/25/08	6
2 Amerivon Equity Partners	3/1/06	1	41 Intel Capital	7/23/05	2
3 Arcadia Ventures (Campbell & Miner)	3/30/06	1	42 Intellectual Ventures	3/2/07	2
4 ARCH Venture Partners	12/8/06	6	43 Keiretsu Forum (Todd Dean)	2/1/07	3
5 Battelle Ventures		1	44 Madrona Venture Fund III	2/27/08	13
6 Blue Point Capital Partners	8/6/08	3	45 Maveron	3/23/07	2
7 Blueprint Ventures (Portland partner)	8/8/05	2	46 Northern Lights Ventures	1/25/07	1
8 Buerk Dale Victor	4/26/07	17	47 Northwest Venture Associates	11/1/07	16
9 Cascadia Capital	5/16/05	2	48 Northwest Entrepreneur Network	7/26/06	4
10 Cascadia Partners	12/2/05	1	49 N W Location Professionals		1
11 Capitol Health	6/18/08	3	50 Obsidian Investment Advisors		1
12 Chrysalix (BC)	3/29/05	1	51 Orca Bay Partners		1
13 Column Group, The	3/21/07	3	52 Oregon Entrepreneur Forum	4/21/05	1
14 Community Capital Management	6/27/07	1	53 OVP Venture Partners	5/7/07	11
15 Compass Capital	6/6/05	1	54 Pacific Horizon Venture Partners IV		4
16 Copan Fund II		1	55 Paladin Partners	12/6/07	2
17 Delta Plant Technology	6/6/07	4	56 Piper Jaffray (Clean Tech)	9/26/08	5
18 DFJ Frontier	1/25/08	2	57 Polaris	11/2/05	1
19 Divergent Venture Partners	2/22/06	3	58 Quellos Capital	9/12/05	3
20 Eastven		1	59 Raven Capital	3/24/05	1
21 Elliott Bay Capital	2/2/07	1	60 Riverlake	11/2/07	1
22 Encompass Ventures (formerly WSA Ventures)		2	61 Rustic Canyon	9/7/07	2
23 Endeavour Capital	11/4/08	13	62 SeaPoint Ventures	9/22/08	5
24 Equilibrium	4/30/08	2	63 SERAPH Capital Forum	9/25/08	1
25 Evergreen Pacific Partners	4/18/08	9	64 Smart Starters	1/28/08	2
26 Fluke Venture Partners	2/27/08	6	65 Staenberg Venture Partners		2
27 Fontis Partners (Ethnic Media)		1	66 Stratos Biofund		4
28 Frazier Healthcare	6/2/06	6	67 Thompson River Capital	9/22/08	2
29 Frazier Technology Ventures	7/16/08	9	68 Trilogy Partners	6/2/06	1
30 Fulton Ventures (Dr. Samir Master)	7/16/08	4	69 Unnamed	6/20/08	6
31 Guide Ventures		3	70 UV Capital	1/18/08	1
32 Highbury Pacific Capital	6/19/07	1	71 vSpring Venture Capital	8/1/08	1
33 Highway 12 (Boise, ID)		2	72 Village Ventures		2
34 IDG	6/2/05	2	73 Voyager Capital	7/16/08	9
35 Ignition Partners	2/27/08	5	74 Vulcan Capital	4/25/07	3
36 Ignition Capital Partner	2/27/08	2	75 WIN Partners	3/24/05	2
37 Ignition China Qiming Venture	2/27/08	2	76 WRF	3/18/08	3
38 Imperium Renewables	2/27/08	1	77 WSA Venture Partners (reverted to Encompass)		5
39 Institute for Systems Biology	1/18/08	4	78 Zefram LLC	9/4/07	2

Funds in which WSIB is invested

Italilcs = Funds currently fund raising

* Most current meeting date and number of meetings