
Washington State Investment Board Economically Targeted Investments Policy



**2010 Annual Report
December 16, 2010**

Introduction and Summary

The Washington State Investment Board (WSIB or Board) manages \$76.7 billion in assets for 39 separate state retirement and other trust funds as of September 30, 2010. 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 global asset classes including public equity, fixed income, real estate, tangible assets, and private equity to help control risk and ensure stronger overall performance.

This is the eighth 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, 2010, shows continued interest and activity. Key findings include the following:

- ❖ 41 GPs looked at 1,611 Washington-based opportunities.
- ❖ 1,035 deals were still in the pipeline at September 30, 2010.
- ❖ 20 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 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 billion investment in Washington-based companies represents over 2 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 \$7.6 billion in private equity commitments have yet to be called, representing significant capital ready to put to work as qualified investment opportunities arise. Further, 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 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

effect 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 “designed exclusively to maximize return at a prudent level of risk.” 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 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 the PwC/NVCA MoneyTree Report based on data from Thomson Reuters (MoneyTree Report), U.S. venture capital investing for the first 9 months of 2010 totaled \$16.7 billion, up 30 percent from \$12.9 billion for the same period in 2009. Until the fourth quarter of 2007, quarter-to-quarter investment activity had fluctuated; however, overall it had been fairly stable and trending upward since the third quarter of 2003. With the recent turmoil in the global financial markets, venture capital investing declined through 2008 and the first quarter of 2009 to levels below historical norms, investment levels in all U.S. regions shrunk significantly, and investment in every major industry segment slowed.

The established Software and Life Sciences sectors continued to benefit from a steady commitment of venture capital dollars being put to work within meaningful pockets of innovation. In the third quarter of 2010, the Software industry regained its number one industry position for investment with \$1 billion deployed into 190 rounds, although both dollars and number of deals decreased from the prior quarter. The Biotechnology industry continued to earn strong interest, capturing the second highest level of funding of all deals, though dollars and deals were both roughly 30 percent lower than second quarter. Medical Devices and Equipment ranked third overall for the quarter with a decline in dollars and deal volume.

Cleantech (comprised of alternative energy, pollution and recycling, power supplies, and conservation) is an emerging sector that crosses traditional MoneyTree sectors; it recorded a 59 percent decrease in dollars to \$625 million and 26 percent decrease over the second quarter to 58 deals completed. The decreases were largely driven by a lack of large rounds in this arena which had been prevalent in previous quarters.

Fourteen of the 17 MoneyTree sectors sustained dollar declines in the third quarter, including Media and Entertainment, Networking and Equipment, Electronics/Instrumentation and Semiconductors. Sectors which experienced increases in investment were Healthcare Services, IT Services and Telecommunications.

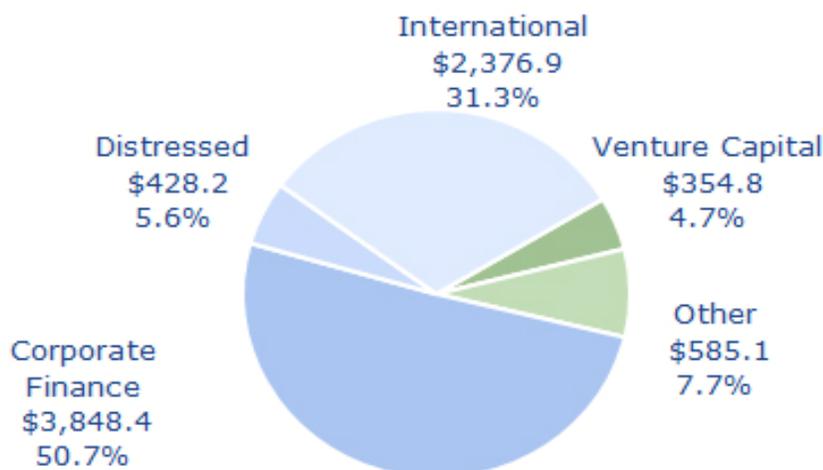
For the third quarter of 2010, most deals—35 percent of total deal volume—were completed in Early stage with \$1.3 billion going into 271 financing rounds; this is consistent with the prior quarter when Early stage deal volume also drew 35 percent of all venture deals. Seed stage deals accounted for 11 percent of total deal volume. Expansion stage deals remained relatively flat to prior quarters receiving 29 percent of the deals. First-time financings for the quarter remained relatively steady with \$1.2 billion going into 255 deals, marking the fourth consecutive quarter with more than \$1 billion invested in companies for the first time. Early stage companies continued to receive the bulk of the first-time financings with 45 percent of the dollars and 54 percent of the deals, apparently reflecting continued greater interest in the potential opportunities represented in young companies.

Private equity fundraising activity decelerated with 120 buyout and mezzanine funds raising only \$32.8 billion and 94 venture capital funds raising only \$6.1 billion during the first half of 2010. The number of buyout and mezzanine funds being raised increased from 68 to 120 over the same period last year; however, the total dollars decreased over 21 percent. The number of venture firms fundraising increased over 22 percent, though the capital raised decreased over 10 percent over the same period last year. Follow-on venture capital funds continued to outpace as fundraisers; the ratio of follow-on funds raised compared to first time funds was nearly 2.6-to-1. The National Venture Capital Association (NVCA) expects fund sizes to continue to get smaller and fewer firms to raise money during this time when venture capital investment is consistently outpacing fundraising. The result is likely a considerably smaller industry in the next decade, which most venture capitalists and their limited partners believe will drive future returns upward without harming innovation. Firms which did not recently raise capital are likely to wait to pursue fundraising until the exit market has improved and provided representative realized performance.

Following several prior years of very heavy fundraising, 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 forces focus 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 \$7.6 billion WSIB private equity overhang by strategy at June 30, 2010, points out that over half the unfunded commitments are in the area of corporate finance, nearly one third are in international strategies, and less than 5 percent are in the venture capital arena.

**Portfolio Allocation by Strategy Based on
Unfunded Commitments at June 30, 2010 (\$ millions)**



Compared to the 12 months ended June 30, 2009, the MoneyTree Report reflects double digit increases in dollars invested in Washington, the Northwest, and the U.S. for the comparable period ended June 30, 2010. In the most current 12 month period, venture capital investments in the U.S. totaled \$22.4 billion in 3,289 deals, up 11 percent and 4 percent, respectively. Of that U.S. total, \$916.4 million (up 37 percent) was invested in 149 deals (down 7 percent) in the Northwest region (defined as Washington, Oregon, Idaho, Montana, and Wyoming). Washington captured 114 of the Northwest deals (down 12 percent) and \$712.4 million of the newly invested dollars (up 31 percent). During this same time frame, the WSIB GPs invested over \$2 billion (WSIB's portion) in private equity including \$23.9 million in Washington-based companies. The \$23.9 million is 3.4 percent of the Thompson Reuters reported invested dollars in Washington. Based on the Thompson Reuters data, deals are getting done in Washington despite the impact of the economic downturn.

In the third quarter of 2010, 29 Washington companies raised \$171 million, which is well below the investment levels of 2000 when the average quarterly total was \$678 million. Although no new venture funds were raised in the Northwest region in 2010, the 26 indigenous venture capital funds have raised nearly \$7.4 billion since 1999. The total increases to nearly \$17.5 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 \$14.4 million; \$9.4 million was invested by investors from outside the region; \$1.0 million was from other non-WSIB Washington-based investors; and \$4.0 million (nearly 28 percent of that round) was from the WSIB's Washington-based GP. The WSIB portion is reported as \$0.6 million, or approximately 4.4 percent of the total funding.

Focusing on only the \$0.6 million attributed directly to WSIB in the example overlooks the significance of nearly \$14 million total invested in a Washington-based company by other sources from both in and outside the state. The fair market value of \$153.2 million at June 30, 2010,

reported for private equity invested in Washington is the value remaining of more than \$263.3 million invested by WSIB since 1992 through its GPs, and importantly represents over \$4.66 billion total invested by the WSIB GPs in those same investments. The true impact of the WSIB investment on Washington economy is substantially enhanced by recognizing the total amount invested by the WSIB GPs, not simply the WSIB portion.

According to the NVCA, approximately 75 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 a current 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 2005 through 2010.

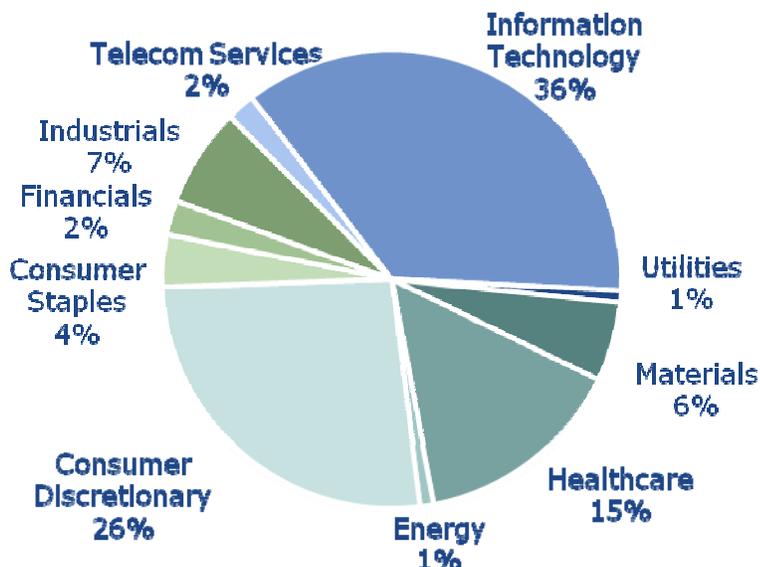
Washington Investments in the WSIB Portfolio						
Investment Class	Value Fiscal Year Ended June 30 (\$millions)					
	2005	2006	2007	2008	2009	2010
Public Equity	\$602.0	\$474.2	\$575.0	\$395.3	\$199.5	\$ 233.8
Fixed Income	\$148.4	\$85.8	\$126.6	\$121.5	\$113.3	\$ 90.9
Real Estate	\$448.6	\$615.7	\$633.6	\$656.3	\$625.2	\$ 586.4
Private Equity	\$66.7	\$95.2	\$105.4	\$144.2	\$92.7	\$ 153.2
TOTAL	\$1,265.7	\$1,270.9	\$1,440.6	\$1,317.3	\$1,030.7	\$1,064.3

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 increased over 17 percent, due mostly to market performance. The 19.8 percent decrease in fixed income value resulted from the sale of a position as part of the overall portfolio repositioning. The 6.2 percent decrease in investment value for real estate in Washington was attributable to depreciation, net acquisitions/dispositions, and financings.

The 65.3 percent increase in value year-over-year for private equity was due to \$23.9 million new in-state investments combined with nearly \$42.9 million net appreciation in the fair market value for various private companies in the past fiscal year, less \$6.2 million returned in distributions. As of June 30, 2010, the WSIB had more than \$153.2 million invested value in Washington-based companies in its private equity portfolio, representing approximately 1.8 percent of the total domestic private equity portfolio value. The Washington-based investments are held in 84 different funds by 45 individual GPs, 5 of which are regionally based. This report is based on June 30, 2010, data, the most current non-publicly traded data available.

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

Percent Invested (FMV) in Washington-Based Companies at June 30, 2010



At June 30, 2010, the WSIB's private equity portfolio, invested with 113 GPs in 272 partnership funds, was valued at over \$13.8 billion. An additional \$7.6 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 2010 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 2010, staff continued its assessment of area funds and conducted numerous meetings with regional funds. The meetings with nearly 100 firms and interested parties in the past 7 years have focused on developing strong 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 or the funds younger 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 continue 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 eighth annual survey of the WSIB private equity GPs by sending letters to 58 GPs requesting information about their deal flow review in Washington for the year ended September 30, 2010, including the number of deals done, number passed, and any still in process. The poll was sent to funds that had not completed their investment periods and that do invest

within the U.S. The results continue to show strong, consistent, and active Washington deal interest. The table below highlights the results.

	Annual Report for the Year:					
	2005	2006	2007	2008	2009	2010
Number of GPs involved	46 of 62	50 of 66	42 of 54	44 of 55	41 of 55	41 of 58
Total deals reviewed	1223	1367	1,139	1,675	1,626	1,611
Deals not pursued	637	823	556	720	507	556
Number of GPs involved	24	34	28	24	23	27
Deals in pipeline	553	493	542	914	1100	1035
Number of GPs involved	15	20	17	20	9	10
Deals done	33	51	41	41	19	20

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 8 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, review deals, and fund their choice of opportunities. The data is also an important reminder that not all deals get done.

Regional Networks

Staff made numerous trips to the Seattle area and contributed to several regional networks.

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

- ❖ Governor's Life Science Summit
- ❖ WBBA Life Science Innovation Northwest
- ❖ Washington Innovation Summit 2010 (Tacoma)
- ❖ OVP Venture Partners Technology Summit
- ❖ 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 7 years, staff has monitored the ETI activities of numerous states and continues 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 targeted investment 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.

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 to monitor targeted investment 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, 2009 through June 30, 2010 (\$ millions)

Washington

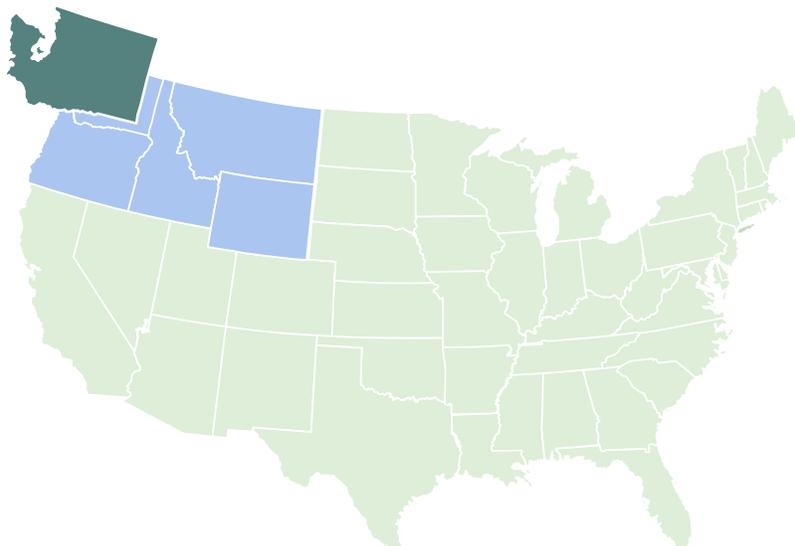
Number of Deals: 114
Amount: \$712.4

Northwest

Number of Deals: 149
Amount: \$916.4

U.S.

Number of Deals: 3,289
Amount: \$22,439.8



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

Meetings with Washington Funds & Related Organizations – August 2003 through November 2010

FIRM	* WSIB MEETING(S)	FIRM	* WSIB MEETING(S)		
1 Altitude Life Science Ventures	1/13/06	1	50 <i>King's Bay Capital</i>	4/3/09	1
2 Amerivon Equity Partners	3/1/06	1	51 Lightspeed Ventures	1/27/09	1
3 Aminex Therapeutics	3/17/10	1	52 Lumira Capital	6/1/10	2
4 AMRI (Bothell)	3/17/09	1	53 Madrona Venture Fund III	5/19/10	15
5 Arcadia Ventures (Campbell & Miner)	3/30/06	1	54 Marquam Hill	1/13/10	1
6 ARCH Venture Partners	5/19/10	7	55 Maveron	3/23/07	2
7 Battelle Ventures		1	56 Milk Ventures	3/16/10	1
8 Blue Point Capital Partners	2/1/10	4	57 NephCor (Rumpler)	10/21/10	1
9 Blueprint Ventures (Portland partner)	8/8/05	2	58 Northern Lights Ventures	1/25/07	1
10 Buerk Dale Victor/Mont Lake	6/24/09	18	59 Northwest Venture Associates	11/1/07	16
11 Capitol Health	6/18/08	3	60 Northwest Entrepreneur Network	7/26/06	4
12 Cascadia Capital	5/16/05	2	61 N W Location Professionals		1
13 Cascadia Partners	12/2/05	1	62 Obsidian Investment Advisors		1
14 Chrysalix (BC)	3/29/05	1	63 Orca Bay Partners		1
15 Column Group, The	3/21/07	3	64 Oregon Entrepreneur Forum	4/21/05	1
16 Community Capital Management	6/27/09	2	65 OVP Venture Partners	6/3/09	15
17 Compass Capital	6/6/05	1	66 Pacific Horizon Venture Partners IV		4
18 Copan Fund II		1	67 Paladin Partners	2/24/10	4
19 Delta Plant Technology	6/6/07	4	68 <i>Piper Jaffray (Clean Tech)</i>	9/15/10	6
20 DFJ Frontier	5/27/09	3	69 <i>Pivotal Investments</i>	9/11/09	2
21 Divergent Venture Partners	2/22/06	3	70 Polaris	3/3/10	5
22 Eastven		1	71 Quellos Capital	9/12/05	3
23 Elliott Bay Capital	2/2/07	1	72 Raven Capital	3/24/05	1
24 Encompass Ventures (formerly WSA Ventures)		2	73 <i>reVera Capital</i>	8/18/09	1
25 Endeavour Capital	4/9/09	14	74 <i>Right Side Angel Fund</i>	10/12/09	1
26 <i>Equilibrium</i>	4/13/09	3	75 <i>Riverlake</i>	11/2/07	1
27 Evergreen Pacific Partners	4/18/08	9	76 Rustic Canyon	9/7/07	2
28 <i>Fluke Venture Partners</i>	2/27/08	6	77 SeaPoint Ventures	9/22/08	5
29 Fontis Partners (Ethnic Media)		1	78 SERAPH Capital Forum	9/25/08	1
30 Frazier Healthcare	6/2/06	6	79 Significant Genomic Lab (L. Rumpler)	3/17/09	1
31 Frazier Technology Ventures	7/16/08	9	80 Sisu Ventures		2
32 Fulton Ventures (Dr. Samir Master)	7/16/08	4	81 Smart Starters	1/28/08	2
33 Glocent Technologies (Hermansen)	7/21/10	2	82 Staenberg Venture Partners		2
34 Guide Ventures		3	83 Stratos Biofund		4
35 Hasselback LLC	3/10/10	3	84 Tate Capital Partners (Chip Treverton)	12/8/08	1
36 H.I.G. Bio Ventures	5/19/10	1	85 <i>Thompson River Capital</i>	9/22/08	2
37 Highbury Pacific Capital	6/19/07	1	86 Trilogy Partners	6/2/06	1
38 Highway 12 (Boise, ID)		2	87 Unnamed	6/20/08	6
39 IDG	6/2/05	2	88 UV Capital	1/18/08	1
40 Ignition Partners	2/27/08	5	89 <i>vSpring Venture Capital</i>	8/1/08	1
41 Ignition Capital Partner	2/27/08	2	90 Village Ventures		2
42 Ignition China (Qiming Venture)	2/27/08	2	91 Volition Capital	5/27/10	1
43 Immusoft	3/17/10	1	92 <i>Voyager Capital</i>	10/20/10	12
44 Imperium Renewables	2/27/08	1	93 Vulcan Capital	8/19/09	4
45 Institute for Systems Biology	1/18/08	4	94 WIN Partners	3/24/05	2
46 Integra Ventures	3/17/09	7	95 WRF	3/16/10	5
47 Intel Capital	7/23/05	2	96 WSA Venture Partners (reverted to Encompass)		5
48 Intellectual Ventures	3/2/07	2	97 Zefram LLC	9/4/07	2
49 Keiretsu Forum	2/1/07	3			

Funds in which WSIB is invested

Italics = Funds currently fund raising

* Most current meeting date and number of meetings