

WASHINGTON STATE INVESTMENT BOARD
Audit Committee Meeting Minutes
March 6, 2012

The Audit Committee met in open public session at the Washington State Investment Board (WSIB) boardroom at 2100 Evergreen Park Drive SW, Olympia, Washington.

Committee Members Present: Steve Hill, Chair
Bill Longbrake
George Masten
Treasurer Jim McIntire
Bob Nakahara (via teleconference)
Natasha Pranger

Committee Members Absent: Senator Lisa Brown

Others Present: Theresa Whitmarsh, Executive Director
Victor Moore, Chief Operating Officer
Shawna Killman, Internal Audit Director
Rodney Reynolds, Internal Auditor
Alicia Markoff, Portfolio Administrator
Beth Vandehey, Risk and Compliance Director
Jen Edwards, Compliance Officer
Chris Green, Risk Analyst
Patty Davis, Administrative Assistant

Steve Dietrich, Assistant Attorney General
Steve Lerch, Economic and Revenue Forecast Council

[Names of other individuals attending the meeting are listed in the permanent record.]

Mr. Hill called the meeting to order at 9:12 a.m. and took roll call.

APPROVAL OF THE DECEMBER 6, 2011, MINUTES

Treasurer McIntire moved to approve the December 6, 2011, Audit Committee meeting minutes. Mr. Masten seconded, and the motion carried unanimously.

INTERNAL AUDIT

Audit Recommendations Status Report

Ms. Killman informed members that since the last quarterly report in December, staff completed the Permanent Funds Asset Allocation study and obtained Board approval. Internal Audit will verify the remaining recommendation regarding completion of the Tangible Assets Oversight Policy, and report status back to the Committee next quarter. Ms. Whitmarsh indicated the policy should be complete by the end of September.

Internal Audit Report – 2012-04 Travel Expenditures

Mr. Reynolds reported to members that Internal Audit has completed the review of the Board's Travel Expenditures as outlined in the Fiscal Year 2011-2012 Internal Audit Plan. Overall, the WSIB is complying with state travel regulations.

One recommendation was made regarding documentation for travel paid directly by outside sources. Management agrees and will examine existing practices and procedures and consider policy changes to improve documentation.

[Ms. Pranger arrived at 9:17 a.m.]

It was suggested by members as an alternative, the WSIB pay for travel expenses up front and be reimbursed by outside sources. Ms. Pranger expressed concern for prohibiting the practice of travel paid by outside sources. Mr. Hill requested staff explore the appropriateness of continuing current practice.

[Mr. Longbrake arrived at 9:22 a.m.]

EXTERNAL AUDIT

Daily Valued Funds Annual Report

Ms. Markoff presented the Daily Valued Funds (DVF) Annual Report and provided members with additional background on basic processes. The DVFs Policy sets forth the Board's responsibilities with respect to the operations of the DVFs. It requires staff to report annually to the Audit Committee all errors below the tolerance level of \$.01 (one cent) per unit value, regardless of the error's source. Errors above the tolerance level are reported immediately to the Executive Director and communicated to the Board. The policy also requires the WSIB to notify the Department of Retirement Systems of any delay in closing that is specific to the WSIB.

There were no errors to the Savings Pool or the WSIB Bond Fund's net asset value in 2011. The calculations were completed for each day's unit price and there were no delays in closing specific to WSIB.

MANAGEMENT

Investment Referrals Quarterly Report

Ms. Whitmarsh offered the information for the members' reference. There were five new referrals, three of which were deemed unsuitable for the WSIB's investment strategy. The remaining two continue to be evaluated by the investment team. Ms. Whitmarsh indicated the referral process is working well and provides transparency for the WSIB.

Annual Investment Compliance Report

Ms. Vandehey and Ms. Edwards presented the Annual Investment Compliance Report. The compliance program reviews the WSIB investment policies and investment manager contracts as part of the overall governance structure of the agency. The compliance work covers approximately 88 percent of assets under management. The remaining assets are held within commingled or index funds and compliance monitoring is not possible. The results for the year are positive.

All public assets were in compliance in 2011, except for the securities lending program which had a few instances of loans not meeting the collateral levels due to timing issues. These levels were increased to the correct amounts the next day.

Mr. Longbrake inquired about the actual number of securities in question. Ms. Vandehey indicated it was three or four out of approximately 1,300 tested per month. It was determined a program rule change was needed at JPMorgan, and it has been implemented. The exceptions have been corrected, and the situation has not reoccurred.

Ms. Edwards reported on investments tested in Private Equity, Real Estate (REOC), and Tangible Assets. All investments were found to be in compliance. Private Equity has been tested for years, while Real Estate investments are being fully tested for the first time. As a result, Private Equity investment testing has become streamlined. Once all the Real Estate investments have been tested, a rotation of testing will begin going forward in 2013 in order to streamline the process.

Ms. Whitmarsh commented on the uniqueness of the WSIB's compliance program. Staff built this program from scratch, and it is viewed as a model by our peers.

Treasurer McIntire inquired if the WSIB imposes a uniform, efficient process for the REOCs. Ms. Vandehey explained how Real Estate contracts are varied, and REOCs are very different than partnerships in Private Equity. Data is difficult to identify and obtain, and testing is not as streamlined.

Enterprise Risk Management Board Governance Discussion

Ms. Vandehey and Mr. Green introduced the Enterprise Risk Management Board Governance discussion with members. At the request of the Governance *ad hoc* Committee in 2011, the Board assigned the task of structuring risk discussions with the Board to the Audit Committee. The Audit Committee Charter 1.00.130 assigns Board-level risk oversight to the Audit Committee. This ensures the Board has a comprehensive policy and framework for an effective system of risk management, as well as mechanisms for assessing their effectiveness.

Ms. Vandehey presented an overview of the current Enterprise Risk Management (ERM) framework, risk management structure, current portfolio risk management hierarchy, and tools currently available to measure and manage investment risk. Within the framework and associated Risk Appetite Statements, the WSIB manages six key risks, one of which is investment risk. Developing the total portfolio risk discussion is a strategic goal for Risk Management this year. Of the approximate eight hours a month Board members spend on managing risk, 52 percent of the time is spent on investment risk.

Further along the framework, Ms. Vandehey showed members how the WSIB currently manages total portfolio investment risk by using risk tools such as asset allocation, capital market assumptions, and qualitative statements of investment beliefs and risk appetite. Risk management is embedded in the current operational structure from the individual asset class manager level up to the total portfolio level. The Asset Allocation policy decision is the primary total portfolio investment risk management tool used by the WSIB. It is reviewed and approved on a four-year cycle. Another total portfolio risk tool is the development and adoption of capital market assumptions which are reviewed and approved annually.

Mr. Green presented existing and new quantitative investment risk tools available from the data warehouse and the risk system that can be used to look at concentration risk and volatility risk at the total portfolio level.

The data warehouse provides portfolio exposures by country or larger geographic region, by industry sector, and by the issuing entity of a security. MSCI's BarraOne Risk System provides volatility measures and stress testing capabilities for the Commingled Trust Fund (CTF). These tools supplement the Investment Officers' due diligence and experience in the investment decision-making and risk management processes.

Mr. Green explained how the risk tools can identify the WSIB's risk exposure to a variety of asset classes. He introduced the BarraOne volatility numbers and explained how they can be used to track the portfolio's response to the market's volatility. He also explained the availability of stress testing from the BarraOne Risk System. The stress tests and volatility information can help the Board understand how the CTF can be expected to perform in both normal markets and times of market stress.

Mr. Green concluded with a brief discussion of liquidity risk. Liquidity risk examines the WSIB's ability to meet its cash flow obligations under different market environments. Unlike volatility risk, there are no risk systems that can accurately capture our liquidity risks; the details and modeling are very specific to us and much manual work is required. This limits how often staff can formally report on liquidity risk to the Board. Staff engaged Pension Consulting Alliance Inc. to perform some liquidity analyses on the CTF; the results will be presented at the July off-site planning session.

Discussion ensued on concentration, volatility, and the impact of extreme events to the portfolio. Treasurer McIntire suggested high volatility in investments can impact contributions. He also commented that one of the reasons the WSIB has a top performing pension fund is its focus on performance, not policy. Chair Hill questioned whether we are getting paid for the volatility risk we have assumed in our investments.

Mr. Longbrake restated his position as seeing greater value in looking at extreme situations. He also stated he was uncomfortable with the term 'tactical' in the context of responding to investment decisions. He felt it should be approached with a more long-term, 'strategic' perspective.

Mr. Nakahara inquired how the investment team is using the risk tools in managing strategic risk, including volatility and concentration, and what value it brings to the WSIB. He requested the next risk discussion include feedback from the investment team.

Chair Hill praised the Risk and Compliance staff for a job well done. He also requested some testing be done at the extremes and suggested that having an outside source (such as Rick Funston) review our risk system and report their opinion on its appropriateness to the Board would be useful.

Ms. Whitmarsh commented she believes the WSIB is on the right track. Staff will continue development of the risk system, as it adds value to the investment process. Staff works hard to embed risk framework discussions into every aspect of WSIB's business culture.

Treasurer McIntire requested a heat map analysis to examine the human capital risks.

Research Overview: Proxy Voting and Equity Returns

Mr. Lerch provided a brief overview of research examining the impact of shareholder activism (such as proxy voting) on stock prices. It was determined that conclusions vary, and identifying the true impact of shareholder activism is difficult due to analytic challenges presented by such research. There is much research that results in conflicting conclusions.

As a result, shareholders should rely on their logical beliefs regarding the impact of shareholder activism rather than looking to research literature to confirm or deny those beliefs.

Discussion ensued on what approach the WSIB should pursue regarding shareholder activism. Mr. Masten suggested the WSIB take on specific issues that impact the WSIB.

Internal Audit Report 2012-02 Real Estate Operating Companies
Internal Audit Director Annual Performance Evaluation

Chair Hill announced the Committee would now go into executive session. The executive session is to discuss financial and commercial information relating to investments and to review and discuss the performance of a public employee.

[The Audit Committee went into executive session at 10:58 a.m., and reconvened in open session at 11:49 a.m.]

There was no further business to come before the Committee and the meeting adjourned at 11:49 a.m.