STATE OF WASHINGTON
STATE INVESTMENT BOARD

Board Meeting
Minutes

January 16, 2003

The Washington State Investment Board (WSIB) met in open public session at 9:44 a.m. in the boardroom at 2424 Heritage Court, Olympia, Washington.

Present:	John Charles Deborah Brookman Glenn Gorton Charlie Kaminski John Magnuson George Masten Gary Moore Mike Murphy Bob Nakahara Lee Ann Prielipp Representative Helen Sommers Patrick McElligott Jeff Hanna Senator James West
Absent:	Jeff Seely
Also Present:	Joe Dear Gary Bruebaker Steve Draper Sue Hedrick Jeff Lane, Senior Assistant Attorney General Michael Humphrey, Courtland Partners

[Names of other individuals attending the meeting are not included in the minutes, but are listed in the permanent record.]

Chair Charles called the meeting to order at 9: 44 a.m. and identified members in attendance.

ADOPTION OF MINUTES – December 19, 2002

Mr. Masten moved to adopt the Board minutes of December 19, 2003. Ms. Prielipp seconded the motion, and the motion carried unanimously.

Mr. Dear said there was an incorrect date on Page 6. 1981 should be 1982 in the middle paragraph. Chair Charles noted the correction and the motion was approved unanimously.

OATH OF OFFICE – Senator James West

The Oath of Office was administered to Senator James West, who was appointed by Lieutenant Governor Brad Owen, President of the Senate, to the legislative position representing the Washington State Senate, for a term ending December 31, 2004.

PUBLIC COMMENT

There was no public comment.

QUARTERLY PERFORMANCE REPORT – REAL ESTATE – COURTLAND PARTNERS

Chair Charles introduced Gary Bruebaker who then introduced Michael Humphrey, with Courtland Partners. Mr. Humphrey was joined by Steve Draper, the new senior investment officer for Real Estate. Mr. Humphrey provided the quarterly performance report for the commingled retirement fund real estate portfolio, for the third quarter ending September 30, 2002.

The real estate portfolio has a current market value of $3.65 billion, for the third quarter, ending September 30, 2002, and unfunded commitments of about 3.2 billion.

Mr. Humphrey talked about the state of the economy and the impact that economic changes have had on the markets in which the investments are located. Mr. Humphrey said there have been some reductions in employment and contraction in certain industries such as telecom and technology and those have impacted the office portfolio as well as the industrial and apartment portfolios owned by the WSIB.

Mr. Humphrey said that the portfolio has done well up to this point. The Board has $3 billion already committed for future investment, which is very significant because it will put the fund in a good position to take advantage of the value declines expected to occur in the real estate market going forward.

Mr. Humphrey discussed the portfolio return summary. The total net return for the three-year period is 11.7 percent, total five-year return is 10.8 percent. Inflation for the three-year period was 2.7 percent; for the five-year period, it was about 2.3 percent. Therefore, the three and five-year returns net-of-fees and adjusted for inflation are in the 8.5 and 9 percent range. Mr. Humphrey said this is good performance and above what real estate has provided historically as an asset class over the long term. Typically, real estate is expected to provide a net inflation adjusted return of about 5

percent. Mr. Humphrey also cautioned, though, that this is a dynamic portfolio, and as such, could be subject to potential write-downs in the future.

Mr. Humphrey then reviewed the portfolio investments. There are 25 investments in the portfolio. The ten largest comprise about 75 percent of the portfolio, and Mr. Humphrey focused his comments on those top ten.

The national office vacancy rate, estimated to be between 16 and 18 percent, the possibility of war in the Middle East, and increased terrorism have created some unanticipated and interesting challenges.

Mr. Humphrey said that the Board's largest investment, Principal Enterprise Capital (PEC), has a net asset value of about $417.5 million, and it has benefited from some of the changing market conditions. Currently, it has a 44 percent exposure to retail strip centers, which have done very well. Over the last 12 months, PEC exceeded projected returns. The most important return in the market volatility is the income return, and PEC's one-year income return is 9.5 percent.

Union Square generated $30 million of cash flow distributions to the fund for the year 2002. Net operating income was more than $38 million with some of that money being retained for capital expenditures and tenant improvements. The combined project is about 90 percent occupied. The market vacancy rate is about 15 percent. Based on the 4th quarter cash flow, there was about an 8 percent cash flow return and below a 10 percent net operating income return. Both are positive features.

Olympia Properties has $383 million invested. It has generated about an 8 percent plus return. For the one-year return, roughly 9 percent of that is income, and there have been some write-downs, which have resulted from weakening markets. Mr. Humphrey said the biggest problem in this portfolio is a large industrial portfolio in Columbus, Ohio, that has some vacancy issues.

For Hawthorne Timber, the performances have not been good due to market conditions beyond the control of investment managers. Tariffs have been placed on Canadian timber. In response, Canadians have increased their production over the last year, causing soft prices.

PacTrust is about 96 percent occupied and has done well. It's had an 11 percent income return. There have been some challenges with a tenant going bankrupt.

Lowe NW has performed well. The one-year return is at about 12.7 percent. The income return has been about 13 percent. The one problem asset is an office building in Cincinnati, Ohio. That market is soft and they're having some challenges.

LoneStar III continues to do well. There's been a 26 percent appreciation over the one-year period, taking advantage of the non-performing loan market in Japan.

EuroInvest is about 80 percent office. The partnership has benefited this year from currency exchange rates. EuroInvest's exposure to the British Pound is about 32 percent; to the Euro is about 23 percent; the one-year return of 9.7 percent reflects the positive changes that have occurred in the

currency markets. Almost 300 basis points of that 9.7 percent one-year return is due to the currency exchange rate changes.

Mr. Magnuson asked what the effect a possible war in Iraq might have on that currency hedge. Mr. Humphrey said they would be discussing that later in the day. The U.K. market has correlated well with the U.S. market. The result has been that we're a seller in the U.K. market. Overall, there's been about an 8 percent income return provided by EuroInvest's investments.

Mr. Humphrey also said the international issues are a real challenge because it is difficult to forecast the effect a war in the Middle East would have on the currency exchange rates and other things. The bigger issue is what the impact will potentially be on the market that we're directly invested in. And if the result is an adverse one, the valuation changes could outstrip the currency benefits. That's something they are very focused on. The portfolio is currently 20 percent international, a relatively high exposure. However, having diversification across economies greatly reduces the portfolio risk.

Mr. Magnuson asked if they consider all of the 20 percent opportunistic? Mr. Humphrey responded that the LoneStar and the MSREF investments are opportunistic, but the EuroInvest exposure is more value-added.

Mr. Draper said that EuroInvest owns higher-quality buildings and sometimes has higher-quality tenants.

Pac/SIB is an investment that has performed very well in the past. At this point, they are experiencing some real challenges. They have developed some properties and have some exposures in markets that have been hit by the contraction of the telecom and technology industries, particularly in San Jose, Austin and Dallas. Their portfolio occupancy rate has gone from 97 percent in the first quarter of 2001 to 86 percent, currently. As a result, they project a 12 percent write-down during the fourth quarter, which will offset their 12 percent income return for the year, giving the WSIB a zero percent return. There have been some surprises at how soft the market has become. They're being aggressive, they're doing the right thing, but they have some challenges.

Mr. Magnuson asked, after the write-downs, are the returns measured against the adjusted basis or the original investment? Mr. Humphrey replied they are measured against the original investment.

Mr. Draper said this is not a 20 percent risk investment, it's more like 12 or 13 percent risk. Pac/SIB has very high quality properties. They can expect a zero return for a couple of years. But, compared to competitors who are writing things off in double-digit numbers, the zero is a good number.

Mr. Humphrey said they track different investments for their clients including value-opportunistic investments, and these types of dips are to be expected. What they focus on is what the management is doing, and what is the strategy going forward. Are they reasonable in their assessments of the current market conditions, and how are they going to invest going forward?

Hometown has had a 21 percent return for the one-year period, and 10 percent of that came from the WSIB acquiring the other investors' position in the company. The WSIB is now a 98.7 percent owner of Hometown. Hometown doesn't expect as much appreciation going forward.

Mr. Humphrey said that the top ten investments have had high-income returns that will sustain the performance during the downturn.

He said that some of the other investments have had some pretty interesting developments. MSREF III have projected their gross return for the fund at 25 percent. They recently sold a property in Paris that generated a 40 percent IRR; it was the largest office property sale of its kind in Paris, and it did good things for the fund.

Some of the others did well. JER Fund I also experienced a 15 percent return over the one-year period. They've also benefited by currency changes.

Mr. Magnuson asked if they didn't have some significant write-downs also? Mr. Humphrey answered yes, but the 15 percent took the write-downs into effect as well.

Mr. Hanna asked if Hometown was where management had a big stake? Mr. Draper said no, it was originally structured as a commingled vehicle, with five investors, and it was an operating company. About two years ago, in the Private Markets Committee, it was agreed to buy out the other investors. It's a relatively stable asset class. What happened is that the WSIB took all of the other investors out and all that is remaining is the management team, which has put in some more money alongside the WSIB.

Mr. Hanna also asked about the currency exposure. He presumed that many of those assets are leveraged. Do we borrow Sterling?

Mr. Humphrey said yes, there are borrowings in the different currencies depending on what the rates are and what's most attractive at the time. We do have net currency exposures in some of the portfolios; EuroInvest is probably our largest.

Mr. Draper added that, in the case of Morgan Stanley funds and the LoneStar funds, there are groups that try to hedge their positions as well as borrow on local currency. EuroInvest does borrow in local currency, but does not hedge, so we are exposed there, and while these returns have benefited quite a bit this year, a few years ago, they were hit for the same reason.

Mr. Hanna said that one of the issues at the Board is the overall cash flow of the overall portfolio, not just real estate. Even though real estate has been a very attractive feature of a very high-income return, don't we have something more than $3 billion in commitments outstanding? Is it true we'll probably have a negative cash flow in our overall real estate portfolio for the next several years, just because we're ramping it up and investing more and trying to get a higher percentage of real estate, even though we've had this high-income return?

Mr. Bruebaker responded that he hopes the answer is yes. We have about 10.2 percent of the portfolio in real estate today, with a target allocation of 12 percent. Over the next year, we're going to want to put more money to work than we probably will be able to invest.

He referred to page 8 of Mr. Humphrey's report, which showed the types of control classifications within that asset class. When we get to the place where we need to start taking money off the table, we will be able do that because we are not passive investors. The WSIB has much more direct control over real estate than the typical public fund.

Mr. Humphrey referred to page 14 in the report. He said that capital contributions over the last four quarters are close to a billion dollars. The distributions column represents what we receive in cash distributions. The income represents the income reported by the partners on a fund basis. Net cash flow at the fund level is negative because the portfolio is growing.

Mr. Hanna said that he is worried about cash flow, and was wondering if, despite the very good income, the CTF is actually in a negative cash flow over the next few years, but it can be controlled by selling something. Mr. Bruebaker agreed.

Mr. Humphrey said that, in the distributions column, there is a fairly solid one-year performance in terms of cash flow distributed back to the fund. He anticipates that we will continue to see that level of distributions. Right now, during the economic downturn, the fixed income component of the portfolio coming through is the income payments. An 8 percent income return compares very favorably to the ten-year U.S. treasury.

Mr. Moore responded to Mr. Hanna's question. He said it's important to remember that, in the last recession, the WSIB pulled back from real estate and missed a lot of opportunities coming out of the recession. He agreed with Mr. Bruebaker that there was a deliberate strategy employed to take control, and the staff and consultants worked very well with the general partners in terms of the exit strategies for holdings within the partnerships, and that's where they see the distributions that have done quite well. He said that staff have done a great job with the consultants of making sure that those concerns were addressed while still taking advantage of the extraordinary earning opportunities in real estate.

Mr. Magnuson asked if we can correlate returns based on the level of control? Is our strategy there to achieve balance or to go to an overweighting of full control with more core properties?

Mr. Humphrey said that what Courtland likes about full control is that it permits the investor to step in when things are not going as expected. They focus on diagramming different levels of control. Assuming that all of the commitments are currently invested, the CTF will go from a 32 percent core exposure to 19 percent, the value component goes from 45 to 50 percent and the opportunistic goes from 23 to 31 percent. It might appear then, that the portfolio is getting riskier, but he feels that the risk is being offset by the enhancement of control over those investments.

Mr. Draper added that the pie charts on page 7 are a little deceptive because, with some of the partnerships that are classified in the value-added risk class, once they add the value, most of the

partners are not out selling those properties; they're holding out for long-term income appreciation, so the properties would be considered core properties.

Mr. Nakahara said that, in looking at the one-year return of the portfolio, it seems counterintuitive because they are heavily skewed toward commercial office buildings – which is weak at best – and the West Coast. The reason he raised this is because he did a walk-through of the Bank of America building the day before, and there was a lot of vacant space. In 1998 and 1999, it was definitely a seller's market with 2 percent vacancy rates in Seattle. Until November of last year, his company had a Class A office space in a 22-story building in downtown Seattle, and it was noticeably empty. They asked the building management firm about it and they said they had a 35 percent vacancy rate. In 1998 and 1999, things were so good, they forced the rents higher and asked the tenants to sign long-term leases. But, the bad news on that is, all of a sudden things have started dropping off because the long-term leases are expiring.

With that in mind, Mr. Nakahara asked Mr. Humphrey if this is something he looks at in terms of when is the next shoe going to drop?

Mr. Humphrey said yes. One of the things Courtland did recently in anticipation of the strategy meeting this afternoon was to ask all of the partners to complete a strategy questionnaire. One of the things they look for is what types of vacancies do they anticipate going forward, and what they get back is a rollover schedule (i.e. over the next five years, we expect 10 percent next year, 15 percent the following year, 30 percent the next year of the tenants to roll in terms of their leases coming up for renewal). That is a concern. The high-income returns are based, to a certain degree, on rental rates that were negotiated during the tight-demand periods, and they are over-market, in some cases. He said that leasing, rollover, and tenant-financial conditions are something they continue to watch.

Mr. Nakahara pointed out that, in the case of the nearly vacant building he was in, it showed a 35 percent vacancy, but the vacancy is actually 10 percent because of the long-term contracts. There won't be any reason to re-up because there aren't actually any tenants occupying those spaces. He wondered if we aren't going to be surprised in 2003 or 2004 by looking at these return characteristics and then wonder what happened to our commercial office buildings? He asked when Courtland would finish their analysis.

Mr. Humphrey said that it will be an ongoing activity. He said they think they are coming close to where they were in the early to mid-90s. He also said they are a long way from vacancy rates hitting 10 percent.

Mr. Draper added that, in comparing to the NCREIF number, during the spike, many institutions aggressively wrote up their portfolios in order to show great returns, and now they're writing them down, and that's going to continue. He said our partners have tried to be conservative and to look at what they think the long-term rental level is rather than writing up and down in spikes. He said there will be some write-downs, and it shouldn't be a surprise that these returns will go down over the next couple of years.

Mr. Humphrey agreed that there are going to be write-downs and resulting fallout, but what they want to stay on top of is making sure that the partners and managers are focused on getting what they can for the portfolio and protecting it for the mid- to long-term.

Chair Charles asked if there were any additional questions or comments.

Mr. Draper referred to page 9 in the report. He said they are 20 percent outside the U.S. currently, by design, trying to take advantage of where they see the best opportunities, which are primarily outside of the U.S. The WSIB has a substantial amount of money committed outside of the U.S. in LoneStar and MSREF funds. This number, even if the WSIB made no new investments going forward, will increase. And it's very likely, with the conditions in the U.S., that that international number probably will peak above the 25 percent range in the guidelines in the next two years, and then start trailing off.

Mr. Murphy referred to page 9 and asked if the 20 percent in the other category was an even distribution amongst those three categories? Mr. Draper said no, the 20 percent could almost be divided in half between timber land and distressed loans. Mr. Murphy suggested that the footnote should indicate natural resources and distressed loans.

Mr. Masten asked if what is happening in North Korea is having any impact on WSIB investments in Japan and South Korea? Mr. Draper replied that, at the LoneStar committee meeting recently, that question was posed and LoneStar said Koreans didn't seem worked up about this. Mr. Draper said there is potentially an exposure there, but it was important to bear in mind that our exposure, especially in Japan, is based on distress. So, to the extent that things continue to be bad there, it is good for us.

Mr. Draper said the WSIB does look different than NCREIF, and should look different if we are trying to outperform NCREIF. We are overweighted in some areas and underweighted in some. That will smooth out a bit as those things shift over time. We are underweighted in some of the regions. We're focused on long-term growth markets, and give the Board additional return. With the five-year return being very similar to NCREIF, we have tripled the size of the equity during that five-year period. The vast majority of the investments in real estate are still adding value and creating returns. The fact that these returns are equal to NCREIF over five years, while the majority of them have little, if any return, is actually very encouraging.

That concluded the report. [A recess was taken at 10:55 a.m. The Board reconvened at 11:00 a.m.]

ADMINISTRATIVE COMMITTEE REPORT

Chair Charles gave the Administrative Committee report. He said that a pressing administrative issue took up most of the time. There was a report from the executive director with regard to performance expectations that the Administrative Committee had presented in negotiation with the executive director. The Committee will continue work on economically targeted investments (ETI). It is an important issue that will require a lot of discussion. The Board does have a policy that was written during the last economic downturn about 20 years ago. The Committee will review it to see if any changes should be made.

AUDIT COMMITTEE REPORT
There was nothing to report.

PUBLIC MARKETS COMMITTEE REPORT
There was nothing to report.

PRIVATE MARKETS COMMITTEE REPORT
There was nothing to report.

EXECUTIVE STAFF'S REPORT
Monthly Management Report
Mr. Dear described the Board Governance workshop scheduled for January 23rd and 24th. He said Cortex Applied Research was selected, after a competitive process, as the consultant for the workshop. Cortex Applied Research is a specialist firm that works with fiduciaries to develop strategies and policies for governing pension funds. There was also a very good proposal from Mercer Investment Consulting. Mr. Dear said he looks forward to the workshop and is very pleased that, with the exception of the legislative members who cannot attend due to the legislative session, all of the members of the Board will be attending.

Mr. Dear discussed results of the employee survey conducted in December. Some of the items identified as needing work are communications by senior management to the rest of the agency. The staff also feels encumbered by rigid policies and procedures, which may not be supportive of efficient and effective regular work. He said all staff would step away from regular operations tomorrow and spend it identifying those things that do not add value and then eliminate them immediately, if possible. Opportunities for further improvement will be identified for follow-up.

Mr. Dear said the Administrative Committee briefly discussed his work plan. He revised it to incorporate the very good suggestions he received from the Administrative Committee. He has also developed a list of the top 10 goals for 2003.

On the legislative front, Mr. Dear said that he testified before the House Financial Institutions and Insurance Committee this week, providing an overview on the State Investment Board. He met with a number of legislators and constituents who are very interested in economically targeted investment (ETI) and are considering legislative proposals in that area. He listened to them and described what the Board is doing about the ETI policy. He has also been talking with the chair, staff and stakeholders of the House Trade and Economic Development Committee, which will be holding a hearing next week on ETIs.

Mr. Dear said the move to the new building is on schedule, and the plan is to occupy it on February 18th. Staff will be moving over the President's Day weekend. One change from the prior plan will be to purchase a new phone system so that it will integrate with forthcoming improvements in the WSIB's information technology platform. It will be slightly over budget, but not significantly, and it can be covered with the current appropriation. Mr. Dear also said he is very cognizant of the fact that they are moving, purchasing furniture and incurring additional expense in a budget climate that

is extremely difficult. He said he is trying to be as sensitive as possible to that, but does not want to miss opportunities to make improvements that will increase the long-term effectiveness of the organization.

Monthly Investment Reports
Mr. Bruebaker provided the December monthly performance report. For the month of December, the Commingled Trust Fund (CTF) is down 1.3 percent. The balance of the fund, as of December 31, 2002, is at $36.9 billion, down $617 million. Fiscal year to-date, performance is down 3.8 percent. The total assets under management, as of December 31, 2002, are at $49.2 billion, down $587 million.

Some areas are progressing very well for the 2003 targets. Real estate is one area; they are still on target towards the private equity. U.S. equity and private equity were added together, and fixed income and real estate were added together as directed by the Board a year ago for the transitional allocations. This time, they are within allocation on every asset class, standing alone as well as with the combined. For the month in real estate, they had seven draws and 11 distributions; within private equity, they had 34 draws and 32 distributions. So activity is up a little bit.

For the capital market environment in the month of December, with the exception of fixed income, all of the equities are down. The Wilshire 5000, our benchmark for our domestic equity, for December was down 5.5 percent, for the month of January through the close of markets yesterday, it was up 4.8 percent.

Daily Priced Investment Options Quarterly Report
Mr. Bruebaker then presented the investment performance report for the Daily-Priced Investment Options for the fourth quarter, ending December 31, 2002. The Savings Pool is at $524 million; it is up $21 million from the previous quarter. The average maturity is extending a little bit at 2.6 years, last quarter it was at 2.3. The yield is down slightly from 5.84 to 5.58 percent. They have the same line-up in terms of the top 10 issuers. There is a 7.5 percent allocation of cash, which they are bringing down to 5 percent. So, where they have $39 million in cash today, it will be moved down to $26 million. This is another one where the cash flows are managed every day.

The Bond Fund is at $257 million, up $24.8 million. Performance for that fund is down 56 basis points since inception due to some dicey credits that they decreased their exposure to in the summer that have since come back. They are coming up on their three-year period, July 23, 2003, and they are monitoring performance of this very closely and are expecting to see performance turn around in the next few months. In March, there will be a detailed discussion with the Private Markets Committee on this particular bond fund.

The Short-Horizon Fund at $13.8 million is up $1.5 million. The Mid-Horizon at $31.7 million is up $5.7 million. The Long-Horizon at $25.8 million is up $5.8 million. Performance on each of these since inception is also down. Short-Horizon is down 35 basis points. The Mid-Horizon is down 42 basis points. And the Long-Horizon is down 39 basis points. Most of the underperformance is due to the fact that the bond fund has underperformed and it is the bond element of these balance funds.

Other Business
Chair John Charles recognized Gary Moore who was concluding his term on the board due to his appointment as the new chief negotiator for the state. The Chair read a letter to Mr. Moore, on behalf of the Board and SIB staff, thanking him for his 17 years of service to the Board. He also presented Mr. Moore with a pen engraved with his name, as a token of appreciation.

Mr. Moore then made a few remarks. He said that this has been a wonderful 17-year association, both as a public employee representative on the Board as well as the Labor and Industries ex-officio member. He said he has learned an incredible amount from all of them, and his contribution paled in comparison to what he has taken away. He considered himself fortunate to have had this opportunity.

He said that, when he originally came on the Board in 1986, the assets under management were at $12 billion. He said it shows that the Legislature's decision and the voters' decision to allow the investment of these state funds as it has been done was wise because it's truly been a benefit to the State of Washington, to the beneficiaries of the retirement systems and to systems like the Labor and Industries' workers' compensation fund. Mr. Moore said he would miss everyone and thanked them.

ASSISTANT ATTORNEY GENERAL'S REPORT/EXECUTIVE SESSION
Chair Charles said the final item for the day would be the Assistant Attorney General's litigation report. He said he did not anticipate any further action by the Board, and he announced the Board would go into executive session under the provisions of RCW 42.30.110.1(i). The purpose of the executive session was to discuss with the assistant attorney general the status of the Board's litigation against certain parties related to the Board's investment in securities of Enron and Worldcom and to discuss another matter that might lead to litigation. Chair Charles said he expected the executive session to last at least 15 minutes. Following completion of the executive session, the Board planned to return to its open session and expected to adjourn. The Board did not expect to take any final action regarding the matter to be discussed in executive session.

[The open session concluded at 11:21 a.m. and the executive session convened immediately thereafter. The executive session concluded at 12:04 p.m. and the open public session reconvened immediately thereafter.]

There being no further business to come before the Board, the meeting adjourned at 12:04 p.m.

John Charles
Chair

ATTEST

Joseph A. Dear
Executive Director