WASHINGTON STATE INVESTMENT BOARD

Board Meeting Minutes
July 17, 2003

The Washington State Investment Board met in open public session at 9:35 a.m. in the boardroom at 2100 Evergreen Park Drive SW, Olympia, Washington.

Present:

John Charles, Chair
Debbie Brookman
Jeffrey Hanna
Charlie Kaminski
George Masten
Patrick McElligott
Mike Colleran
John Magnuson
Bob Nakahara
Paul Trause
Glenn Gorton
Dave Scott
Jeff Seely
Representative Helen Sommers
Senator Joseph Zarelli

Also Present:

Joe Dear, Executive Director
Gary Bruebaker, Chief Investment Officer
Sue Hedrick, Executive Assistant
Liz Mendizabal, Communications & Legislative Coordinator
Beth Vandehey, Internal Auditor
Tom Ruggels, Senior Investment Officer, Private Equity
Steve Draper, Senior Investment Officer, Real Estate
Nancy Calkins, Senior Investment Officer, Public Equity
Linda Lester, Investment Officer, Public Equity
Diana Will, Investment Officer, Asset Allocation
Tom Bosworth, Investment Officer, Fixed Income
Gary Holt, Investment Officer, Private Equity
Isabelle Fowler, Investment Officer, Private Equity
Linda Lester, Investment Officer, Public Equity
Lisa Harrison, Assistant Investment Officer,
Steve Verschoor, Investment Accounting Controller
Alicia Markoff, Portfolio Administrator
Kristi Bromley, Administrative Assistant, Investments
Patricia Sheridan, Office Manager

Paul Silver, Assistant Attorney General

[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 and identified the members in attendance.

OATH OF OFFICE – JOSEPH ZARELLI

Chair Charles gave the oath of office to Senator Joseph Zarelli. Senator Zarelli said he knows there is a great responsibility associated with the assignment, and he is looking forward to working with each of the members and doing the job to the best of his abilities.

EXECUTIVE DIRECTOR PERFORMANCE REVIEW

Chair Charles called the Board into executive session at 9:39 a.m. He said the purpose of the executive session was to discuss the performance review of the executive director. The executive session was expected to last until about 10:05, and, at the end of the executive session, the Board would reconvene to take up additional items on the agenda.

[The executive session concluded at 10:18 a.m. and the open public session reconvened immediately thereafter.]

ADOPTION OF MINUTES – June 19, 2003

> **Mr. McElligott moved to adopt the Board minutes of June 19, 2003. Mr. Masten seconded.**
>
> **The motion to approve the minutes carried unanimously.**

PUBLIC COMMENT

There was no public comment.

QUARTERLY PERFORMANCE REPORT – REAL ESTATE

Michael Humphrey of Courtland Partners provided the quarterly performance report for the commingled retirement fund real estate portfolio, for the first quarter of 2003. Mr. Humphrey gave a brief summary of the performance of the fund. The real estate portfolio has a current market value of almost $3.7 billion, and unfunded commitments of almost $3 billion, which does not include the latest Hometown commitment.

Mr. Humphrey said that vacancies have increased and rents have declined in most U.S. markets. However, despite that, the returns from the WSIB's real estate portfolio continue to be strong. He noted that the 5.4 percent appreciation for the one-year return is strong for this part of the market cycle, which is at the bottom. Part of the reason for that is the diversification of the portfolio, particularly the international investments. The three-year income return at 7.3 percent is also strong.

Mr. Humphrey said the top ten investments comprise about 75 percent of the portfolio. He went through the net returns of some of the top investments including PEC, Lowe NW, LoneStar III, MSREF IV International, Olympia Properties, Hawthorne Timber, ForesTree, EuroInvest, and PAC/SIB, and listed some of the areas that have done well.

Mr. Humphrey described the current market conditions for office, industrial, residential and retail and other. In the office market, the vacancy rate has increased nationally to about 16.5 percent; rents have declined about 2 percent due to corporate consolidations. The industrial vacancy rate is up to just over 11 percent nationally. Rents are expected to decline 6 percent this year. Multi-family is bucking the trend. Vacancies are actually down to 6 or 7 percent nationally. Retail has seen an increase in vacancy and rents are expected to increase 1 to 3 percent.

Mr. Humphrey introduced two new pages in his report: Property Type Diversification and Portfolio Geographic Diversification. The charts make a comparison of WSIB investments with the National Council of Real Estate Investment Fiduciaries (NCREIF). He said we are within all of the guidelines. Senator Zarelli said he would like to know how well our investments are doing by specific type of investment and region by region. Mr. Draper responded that this would be challenging, but he would be happy to meet with the Senator to discuss this further.

The Portfolio Geographic Diversification page provides more information on international investing. The WSIB's largest exposures are to California at 23 percent, the Northwest at 14 percent, the Southwest at 10 percent, the Southeast at 10 percent, the Midwest at 9 percent, and International at 22 percent. The table shows the WSIB's international portfolio is largely focused in Asia and Europe, with an exposure to Latin America. Asia is predominantly Japan; Europe is primarily the U.K., France and Italy. In the U.S., the portfolio is underweight in the East, overweight in the West.

Mr. Humphrey referenced the last part of his report, Equity Research – Real Estate Market Cycle Monitor – which shows the four phases of the national property type cycle.

Mr. Magnuson pointed out that we have $3 billion in unfunded commitments. As markets continue to soften, it represents a buying opportunity. He said it is good we have people out there making transactions and selling assets, which is a good thing because real estate is traditionally illiquid. He said we have relatively low leverage, 37 percent on borrowed money, but we are making a return on that money which is prudent.

TIME-WEIGHTED VS. DOLLAR-WEIGHTED PERFORMANCE CALCULATIONS

Gary Bruebaker began the educational session on different ways to calculate return. He introduced Tara Blackburn, Eric Becker, Greg Little and Scott Tuck from Pacific Corporate Group (PCG). Diana Will said the purpose of the session was to better explain why her performance report has different private equity numbers than PCG's performance report.

Ms. Blackburn presented the PCG report. She said that private equity is measured on a dollar-weighted return basis, an IRR basis, and not on a time-weighted return basis. Time-weighted is the

type of measurement used for other asset classes and is used when integrating private equity returns into the total portfolio. She gave some examples of the differences between time-weighted and dollar-weighted returns.

Mr. Becker then discussed the effect of the J curve and reviewed the evaluation tools available for private and public equity. He listed the three methods could be used to integrate a dollar-weighted return into a portfolio typically measured in a time-weighted return.

Ms. Will discussed how she utilizes PCG's numbers for her reports to come up with one return for the Commingled Trust Fund (CTF). She discussed three ways to calculate a total portfolio return, and went through the calculation methodology for all three measurements. She then gave some examples.

ADMINISTRATIVE COMMITTEE REPORT

Chair Charles reported on the July 17 Administrative Committee meeting which focused on the executive director's performance review. He said that the Committee felt the executive director's performance has been favorable and he is moving the organization in the direction that the Board would like to see.

> **Chair Charles moved to increase the executive director's salary at the start of the seventh month period by 2.5 percent in order to give him formal recognition for his good work during his first six months. Mr. Masten seconded.**
>
> **The motion was approved unanimously.**

Mr. Dear said that he likes his job, is proud to be working for the Board and is very happy with the staff that is working with him.

[The Board took a break at 11:56 a.m. and resumed its open session at 12:10 p.m.]

PUBLIC MARKETS COMMITTEE REPORT

Fixed Income – Labor & Industries' Insurance Funds Policy 2.20.100 Revision

Mr. Kaminski reported that the Public Markets Committee met on July 1, 2003, and had three action items for the Board. He said the first is the Committee's recommendation that the Board approve the Public Markets Committee recommendation to authorize the WSIB to be more than 20 percent short the duration target of the liabilities, notwithstanding WSIB Policy 2.20.100, for the Accident Fund until such time as the asset/liability study is completed.

> **Mr. Trause moved that the Board approve the Committee's recommendation. Mr. McElligott seconded. The motion carried unanimously.**

Public Equity – International Program Structure
Mr. Kaminski said the second item for consideration by the Board is the Public Markets Committee's recommendation for the international program structure as presented.

Allocate 5 percent of the international allocation to emerging markets with 100 percent to active management. Allocate the other 95 percent of the international allocation to developed markets with 60 percent of that allocated to active management and 40 percent to passive management. Of the 60 percent allocation to developed markets active management, allocate 40 percent to core, 30 percent to growth and 30 percent to value. Allow the developed markets active managers to opportunistically invest up to 15 percent in emerging markets and up to 10 percent in small cap. Of the 40 percent allocation to developed markets passive management, WSIB staff will issue an RFP that would allow up to 50 percent of this allocation to be managed within an enhanced passive strategy but that would also allow the Board to select all pure passive management.

> **Mr. McElligott moved that the Board approve the Committee's recommendation. Mr. Gorton seconded. The motion carried unanimously.**

Public Equity – Transition Management Service Providers
Mr. Kaminski said the Committee recommended that the Board approve the Public Markets Committee's recommendation to authorize the Executive Director to work with one of the Board's consultants to issue a Request for Proposal to select one or more transition service providers to assist the WSIB with transitions, as appropriate.

> **Mr. Gorton moved that the Board approve the Committee's recommendation. Ms. Brookman seconded. The motion carried unanimously.**

PRIVATE MARKETS COMMMITTEE REPORT
Private Equity Consultant Contract Extension and Amendment
Mr. Masten reported that the Private Markets Committee had two action items for the Board, the private equity consultant contract amendment and extension

> **Mr. Masten moved that the Board authorize the Executive Director to extend the contract through December 31, 2004, as provided in the existing contract terms. Mr. Colleran seconded. The motion carried unanimously.**

> **Mr. Masten then moved that the Board approve the Private Markets Committee's recommendation to approve the attached Amendment No. 1 to Pacific Corporate Group's Contract No. 00-005. Rep. Sommers seconded.**

In March 2002, the Board adopted a revised policy that delegated limited discretion to WSIB staff to make secondary partnership investments of up to $100 million annually. The amendment to PCG's contract would allow them to screen limited partnerships prior to the WSIB investing in

them. PCG would receive 1 percent of the committed capital of successfully closed secondary transactions, paid one time, up to $100 million of commitments annually. The senior investment officer and the chief investment officer would have to approve the transaction before it could be made.

A discussion ensued about success fees to companies such as PCG, the level of risk involved in providing due diligence and making recommendations on secondary partnership investments, and which consultant staff would be involved in these transactions.

The motion carried with Mr. Colleran voting no.

EXECUTIVE STAFF'S REPORT

Executive Director's Report

Mr. Dear presented his report for July. The Board Governance Workshop will be July 31-August 1st and will cover eight policies. They are: Board Education, Service Provider Selection (including investment managers), Executive Director Performance Evaluation, Code of Conduct, Policy Development, Board Self-evaluation, Monitoring and Reporting, and Operations Policy. The second investment workshop will be July 30th.

Mr. Dear introduced Lisa Harrison, the new assistant investment officer for Fixed Income, and mentioned that another investment officer, Janet Kruzel, will join the staff in early August. She will focus on implementing the Economically Targeted Investment Policy. Mr. Dear said that he is very close to filling the deputy director for Operations. Shauna Raphael will leave the agency soon to take a promotion with the State Auditor's Office. Mr. Dear said that he plans to leave that position vacant and handle its workload by shifting responsibilities and improving efficiency. This is the fourth FTE from Operations that may become available for redeployment to the Investment division.

The new money market fund investment option for Plan 3s has changed from State Street Global Advisors to Barclays Global Investors. In the deferred compensation program, the socially balanced fund manager, Calvert, was replaced with Walden Asset Management and the transition went smoothly.

Mr. Dear reported that the website has been redesigned and an Intranet for staff became operational.

Monthly Investment Reports – Gary Bruebaker

Mr. Bruebaker gave the asset allocation report for the month of June. U.S. Equity is up 1.5 percent for the month. Growth stocks outperformed value, small cap outperformed both mid and large-cap for the period. Non-U.S. Equity was up 2.7 percent for the month including Emerging Markets, which were up 5.56 percent. Fixed Income was flat for the month, up 2 basis points outperforming the index by 4 basis points. In Private Equity, no investments closed during the month. Draws for June were $34.5 million, down from our average of $75 million. Distributions were up at $92 million with an average distribution per month of $52.5. KKR's distributions were $36.7 million, while the rest, $55.5 million, came from the other LP portfolio.

In Real Estate, Lowe NW sold an office building in L.A. The Hometown Chateau transaction is expected to close late third or early fourth quarter. Total Assets Under Management are up $93 million over the previous month. The CTF is at almost $38.6 billion, up $102 million from May 31.

Real Estate is the only asset class outside of the long-term allocation targets. Focusing on the transitional ranges, U.S. Equity and Private Equity combined are within their range, as are Real Estate and Fixed Income combined are also within their target range.

This is the third month in a row that all of the indices are positive for the month.

[Mr. Seely left at 12:46 p.m.]

DAILY PRICED INVESTMENT OPTIONS QUARTERLY REPORT
Written reports were included in the packet. There was no verbal report.

ASSISTANT ATTORNEY GENERAL'S REPORT – EXECUTIVE SESSION
Chair Charles called the Board into Executive Session, pursuant to the Open Meetings Act, to discuss with legal counsel litigation or potential litigation to which the SIB is a party or is likely to become a party. Public knowledge regarding these discussions is likely to result in an adverse legal or financial consequence to the WSIB.

Chair Charles said the executive session was expected to last about 15 minutes. After the executive session, the Board anticipated re-convening in public session to adjourn the meeting as no action was anticipated and there were no other remaining matters on the agenda.

[Mr. Hanna left at 12:51 p.m.]

[The open session concluded at 12:50 p.m. and the executive session immediately convened. The executive session concluded at 1:01 p.m. and the open session reconvened immediately thereafter.]

There being no further business to come before the Board, the meeting adjourned at 1:02 p.m.

John Charles
Chair

ATTEST

Joseph A. Dear
Executive Director