# WASHINGTON STATE INVESTMENT BOARD

## Board Meeting Minutes
## November 20, 2003

The Washington State Investment Board met in open public session at 9:39 a.m. in the boardroom at 2100 Evergreen Park Drive SW, Olympia, Washington.

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| Present: | George Masten, Chair<br>Debbie Brookman<br>John Charles<br>Glenn Gorton<br>Jeffrey Hanna<br>Charlie Kaminski<br>John Magnuson<br>Patrick McElligott, Vice-Chair<br>Mike Murphy<br>Bob Nakahara<br>Dave Scott<br>Jeff Seely<br>Paul Trause<br>Senator Joseph Zarelli |
| Absent: | Representative Helen Sommers |
| Also Present: | Joe Dear, Executive Director<br>Gary Bruebaker, Chief Investment Officer<br>Sue Hedrick, Executive Assistant<br><br>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.]

Mr. Masten called the meeting to order and identified the members in attendance.

### ADOPTION OF MINUTES – October 16, 2003

**Mr. McElligott moved to adopt the Board minutes of October 16, 2003. Mr. Charles seconded. The motion to approve the minutes carried unanimously.**

### PUBLIC COMMENT

Mr. Lee Bomberger with the Retired Public Employees Council complimented the board staff on the presentation on private markets at last month's Board meeting. He said the interchange between the board, consultant and general partners was very useful, as were the handouts.

Rowland Thompson, executive director of the Allied Daily Newspapers of Washington, and also representing the Washington Newspaper Publishers Association, commented on the draft public disclosure policy. He said the agency is charged with maximizing returns on behalf of the beneficiaries, but at the same time, the investments are being made on behalf of the public in Washington State. He pointed out that most of the pension funds the WSIB invests are done for union members, and political and public policy implications may be lost when the charge is to maximize returns. He suggested the Board has a strong responsibility to provide the public with information on investments.

Marguerite Young of the Service Employees International Union echoed Mr. Thompson's comments. She agreed that the reconciliation of what to disclose and not disclose should be done carefully to consider the best interests of the public.

[Mr. Kaminski arrived at 9:49 a.m.]

## QUARTERLY PERFORMANCE REPORTS

### Commingled Trust Fund (CTF)

Mr. Bruebaker provided the CTF performance report for the quarter ended September 30, 2003. The Wilshire 5000 index started off the fiscal year on a positive note, earning 3.7 percent; this is only the second positive return in a third quarter period during the last six years. The one-year return remains above average, running at 26.25 percent. Small cap continued to outperform large cap, with the one-year earning about 11 percent more than large cap. Value and growth continue to flip flop, with growth outperforming by 190 basis points for the quarter, earning 4.37 percent compared to the value return of 2.47 percent. For the second quarter in a row, non-U.S. equity markets outperformed U.S equity markets, gaining 8.68 percent as measured by the MSCI ACWI Free ex U.S. Index. The one-year return of 29.04 percent is higher than the U.S. equity market. The 48 countries in the MSCI ACWI Free ex U.S. Index all had positive returns for the year in U.S. dollars, and only two had negative returns for the quarter.

The GDP grew at a rate of 7.2 percent for the quarter. Inflation, as measured by the CPI, grew 0.8 percent for the quarter and 2.3 percent for the year. The Fed continued to hold the fed funds rate at 1.0 percent during the quarter.

The Wilshire 5000 experienced a 16.5 percent return for the second quarter, 7.2 percent for the third, and we're currently at 6.1 percent through October 31, 2003. Capital markets for the third quarter and the one-year are all positive. The Commingled Trust Fund (CTF) total was $39.5 billion at September 30, up $913 million for the quarter. With the exception of cash and real estate, we are within the policy ranges for all of the individual asset classes. The combined range of real estate and fixed income is within the policy ranges.

Total fund performance for the quarter is at 3.6 percent. We are equal to or better than the TUCS public and private for all time periods other than the 3-year period where we underperformed. We outperformed the MAP benchmark for all time periods.

U.S. Equity was at $12.7 billion at September 30, 2003. For each time period, we have outperformed the benchmark with equities. Non-U.S. equities have outperformed for the 3-year and the 5-year, but underperformed for the quarter, the 1-year, and the 10-year. The non-U.S. equity markets have been phenomenal for the last year and the last quarter. Looking at annual returns as of September 30, 2003, for the 48 countries that make up the MSCI ACWI ex U.S., 39 of these countries outperformed U.S. equity markets.

For the breakdown in non-U.S. equities, we have 13.3 percent in emerging markets, the index has 9.5 percent. This was a good quarter to have more money allocated to emerging markets, so that benefited the portfolio. We have $6 billion at work currently in the non-U.S. equity markets.

This was not a good quarter for our developed markets managers. Only one out of seven outperformed their index. Since inception, five of the seven have outperformed; those are the same managers as last quarter.

For the emerging markets managers, three out of five as well as the total outperformed the benchmark. Last quarter, there were two; Schroder brought the number up to three for this quarter.

We continue to see excellent performance by our in-house fixed income managers for all time periods, outperforming the Lehman Universal as well as the Lehman Aggregate.

Private equity is at $5.6 billion. Real estate is at $3.6 billion. We have outperformed for every time period versus the NCREIF + 100 basis points.

**Defined Contribution Plans**
TRS Plan 3 is at $1.8 billion, an increase of $95 million for the quarter. SERS Plan 3 is at $541 million, up $24 million from the previous quarter. PERS Plan 3 is at $719 million, up $278 million for the quarter. The Deferred Compensation Program is at $1.5 billion, up $58 million for the quarter. The Judicial Retirement Account is at $11 million, up $466,000 for the quarter.

The Bond Market Fund is underperforming for the quarter, the 1-year and the 3-year. The Horizon Funds continue to have challenging performance. The Social Balanced Fund is performing well; although, in the five months we have been with that fund, there have been four different pricing errors. They have been put on notice and we will be working with them to correct these errors.

**Labor & Industries (L&I) Funds**
Total Funds under Management at September 30, 2003 were $9.2 billion. We are within the adopted policy ranges for both asset classes. L&I is currently doing an asset liability study with Conning Asset Management. This is scheduled to be finished by February 2004. In terms of performance for the 1-year, we've underperformed the CMI for every single account. We don't manage against the CMIs, but we do use them for comparison purposes. The portfolio credits underperformed the CMI credits due to their longer duration as well as our underweighting the higher beta credits for those assets.

**Permanent and Other Trust Funds**
Total assets under management for the permanent funds are at $726 million, down $7 million from the previous quarter. It was not a good quarter for the investment of the permanent funds. We were hurt by our longer duration. Permanent fund credits also underperformed the index credits because

we have less of the higher beta holdings, and they have been the ones with the best performance in the marketplace. We continue to have excellent long-term performance looking out three, five and 10 years.

This has also been a challenging quarter for the other trust funds, but we continue to have very solid long-term performance over the 3-, 5- and 10-year periods. The GET Portfolio is at $287.7 million, up $16.2 million from the previous quarter. All of the assets are within the policy ranges for the asset allocation. On investment performance for the GET Program, we are down against the passive benchmark by 21 basis points for the quarter, we are down by 94 basis points for the year, but outperforming both the CPI + 450 basis points as well as the absolute return. For the longer periods, we are outperforming the passive benchmark by 74 basis points for the 3-year and by 8 basis points for the 5-year.

The total DDEF Funds are at $6.3 million, up $37,000 from the previous quarter. All assets are within the policy ranges for the asset allocation. The total for the Private Funds is $309,000, up $93,000, a 43 percent increase over the previous quarter. State Funds outperformed each of the benchmarks for the third quarter, the 1-year as well as inception to-date.

**Putnam Investments**
Mr. Bruebaker updated the Board on the Putnam investments situation. The WSIB hired Putnam Investments in June 1999, as the WSIB's only true core developed international equity manager. Putnam managed $584.6 million for the WSIB, as of October 31, 2003. Putnam underperformed for the last three years by 24 basis points. Inception to-date, they have added value of 458 basis points.

Mr. Bruebaker discussed recent events. On Sept 11, 2003, Putnam received subpoenas from regulators. On October 21, 2003, Putnam informed the WSIB that some market timing trades by Putnam employees had occurred. On October 27, 2003, the WSIB placed Putnam on watch list. On November 13, 2003, Putnam reached an agreement with the SEC; they admitted no fault but agreed to make some changes. The reviews by state regulators are continuing. We have been in daily contact with Putnam with the exception of November 11, 2003. We have been in close contact with other pension plans about Putnam and have been receiving information daily from Callan Associates. We have also let Putnam know that we want to know about any organizational and personnel changes immediately.

Mr. Bruebaker reiterated that the WSIB is restructuring its international program over the course of the next few months. He then outlined three alternatives with regard to Putnam: (1) continue to retain Putnam while proceeding with restructuring of the international equity portfolio as scheduled, (2) start an immediate search for a replacement manager, or (3) terminate Putnam and use an existing manager to manage Putnam's assets until a replacement manager is selected.

In response to a question from Mr. Seely, Mr. Bruebaker replied that the Putnam team is fairly deep; they've only lost one player from our investment team. All of the remaining team members are there. Our investment team does manage some mutual funds, but not for the WSIB as we are not invested in any Putnam mutual funds. Mr. Seely also asked about the board structure. Mr. Dear replied that an independent mutual fund board oversees Putnam's mutual funds, but it has no oversight of the WSIB's separate account.

Senator Zarelli asked how much the manager could lose that would adversely affect us more than or as much as the cost of moving to a different manager. Mr. Charles suggested that we try to speed up the transition process. Senator Zarelli also asked if the process could be speeded up in addition to going with option 1. Mr. McElligott spoke in favor of option 1. Discussion followed about performance, transition costs and timing.

> **Mr. McElligott moved that the Board direct staff to proceed with option 1. Ms. Brookman seconded.**

Treasurer Murphy asked Mr. Bruebaker to restate option 1. Mr. Bruebaker said that option 1 is to retain Putnam and continue the intense scrutiny while continuing the transition process. Mr. Charles suggested that staff prepare a comment to explain the basis for the Board's decision on this issue once it has been made.

> **The motion failed.**

[The board took a break at 11 a.m. and reconvened at 11:10 a.m.]

> **Mr. Charles moved that the Board instruct staff to implement option 2 and to conduct an immediate search for a replacement core international equity manager. Mr. McElligott seconded.**

Treasurer Murphy spoke against the motion. He said he would vote against it even though he is in favor of pulling assets from Putnam now because he thinks the transition of the assets should somehow be linked to the entire international equity program restructure. Senator Zarelli said that he feels that option 2 is a reasonable and prudent approach, and it's possible this same situation could happen with other companies. He said this decision would make it clear that we are moving on, but not in a haphazard fashion. Mr. Charles said this motion does not negate the activity in the first motion. Staff will continue to watch Putnam's activities and they can pull the money if it is deemed necessary. Mr. Seely pointed out that the activities of the senior leader of the team were not illegal, although they may still be considered unethical. He agreed that, since the manager's activities are being watched on a daily basis, there is still the possibility of taking more serious action.

> **The motion passed with Treasurer Murphy voting no.**

**Private Equity - Pacific Corporate Group Report**
Mr. Bruebaker introduced Tara Blackburn and Eric Becker from Pacific Corporate Group who presented the quarterly private equity performance report for the quarter ended June 30, 2003. Mr. Becker said the return for the quarter was 5.9 percent. The portfolio appreciated by $315 million, and had positive cash flow of $128 million. During the quarter, a $125 million commitment to GTCR closed. Contributions were down almost 70 percent compared to the prior quarter, from $296 million to $93 million, and distributions were up over 100 percent from $95 million to $222

million. Year to-date contributions and distributions were both down by about 10 percent compared to 2002 year to-date results. The IRR improved from 12.8 percent to 13 percent inception to-date.

The IRR since inception for the KKR portfolio increased from 16.4 percent to 16.5 percent. The LP portfolio also increased from 6.4 to 7.2 percent. Unfunded commitments stand at $1.6 billion for the KKR portfolio, and $3.5 billion for the LP portfolio, as of June 30, 2003.

Mr. Kaminski asked a question concerning the S&P 500 and the S&P 500 + 500 basis points. He said it looks like for the 1-year and longer terms, it is the S&P 500 + 500 that comes up. He was wondering, with the six months and the one quarter numbers, why two and a half and one and a quarter aren't added to the S&P. He asked if that was compounding through linked results. Mr. Becker replied that they are geometrically linked. Mr. Kaminski said it seemed to him to be a large deviation. Ms. Blackburn said they would be happy to provide him with additional information to clarify the reported numbers.

**ADMINISTRATIVE COMMITTEE REPORT**

Mr. Masten reported on the Administrative Committee's meeting earlier in the morning. He said the Committee reviewed the draft public disclosure policy and they asked staff and legal counsel to incorporate the committee's comments then bring the policy back to the Administrative Committee and the Board at a later date. The Committee also had a discussion about due diligence, with no action taken.

Mr. Dear gave an update on the budget. At the last Board meeting, it was reported that a supplemental budget request had been submitted. Staff decided not to pursue that request because WSIB and DRS staff found a way to save $200,000 by not mailing a six-month report, and WSIB staff found that the statute permits the use of non-appropriated funds for salary retention purposes for investment officer staff. Mr. Dear said he was confident that, with those savings and through continuing efficiency improvements, we can reach the amount needed to fund additional investment officer positions.

Mr. Masten said the last item was a strategic plan update. That will be reviewed at a later date.

**PUBLIC MARKETS COMMITTEE REPORT**

There was no report.

**PRIVATE MARKETS COMMMITTEE REPORT**

**Endeavour Capital Fund IV, L.P. – Investment Recommendation**

Ms. Brookman said the Private Markets Committee had two items for action. One was a recommendation to invest $50 million in Endeavour Capital Fund IV, L.P. This investment would be a new general partnership relationship for the WSIB. They have a short, but impressive track record. Since inception in 1993, Endeavour has invested $109 million in 15 companies, producing a net IRR of 21.2 percent as of June 30, 2003. The company has had $65 million in realizations.

The investment team has a strong regional network in the Pacific Northwest, investing in smaller companies at the lower end of the middle market, currently a subsector that is underrepresented in the WSIB portfolio. The strategy is complimentary with minimal overlap with other general partners.

> **Ms. Brookman moved that the Board approve an investment of up to $50 million, plus fees and expenses, in the Endeavour Capital Fund IV, L.P., subject to final negotiation of terms and conditions. Treasurer Murphy seconded. The motion passed unanimously.**

## ASSISTANT ATTORNEY GENERAL'S REPORT – EXECUTIVE SESSION
There was nothing to report.

## EXECUTIVE STAFF'S REPORT
### Executive Director's Report
Mr. Dear presented his report for November. He distributed a list of pre-approved educational conferences. Staff is working with Treasurer Murphy to ensure that the presentation of pertinent information obtained during due diligence reviews on investment opportunities is included for his consideration.

## PRIVATE MARKETS COMMMITTEE REPORT - CONTINUED
### First Reserve Fund X, L.P. – Investment Recommendation
Ms. Brookman said the Private Markets Committee recommended investing $200 million in First Reserve Fund X, L.P., a $2 billion fund that will focus on investments in the energy industry. If approved, this would be a continuation of the existing general partnership relationship that the Board has with First Reserve. The WSIB committed $50 million to First Reserve Fund VIII in 1998, and $100 million to First Reserve IX in 2001.

Ms. Blackburn and Mr. Becker from PCG provided a presentation in response to questions that were raised at the last Private Markets Committee meeting in November.

Treasurer Murphy said he and the Assistant State Treasurer raised concerns that led to the presentation of the additional information because, at the last Private Markets Committee meeting, the material the members were presented with didn't include a discussion of the re-audit of Dresser, Inc. as part of the due diligence presentation. He said that, subsequently, he learned that there was review by PCG and WSIB staff that just wasn't presented to the Committee. He asked about the impact on the financial statements, the IRR and the overall performance of Funds VIII and IX of not having a completed audit of the company's financial statements. He said he was informed that an August deadline for a re-audit that the company missed is now scheduled for December. He pointed out that the company is in technical default on its bonds since it lacks audited financial statements. He urged the Board to wait to make a decision until the new audit comes out to ensure that the company's financial statements are sound.

Ms. Blackburn responded that, with respect to the impact on the two funds in which the investment is held, she did not feel there is any negative impact from the absence of audited financial statements. She said that what they are trying to assess is whether things look like they are on plan and are in keeping with expectations. She said that everything they can glean from working with the manager today leads them to believe that they continue to be comfortable with the investment and there is no reason necessarily to write it down or write it off.

Ms. Blackburn and Mr. Bruebaker then provided additional information on the re-audits of the financial statements and confirmed that the new deadline is December 15. In a conference call the day before with the company, Mr. Bruebaker said he was told that the audit has been completed and there are no material negative impacts on the financial statements. He noted that the firms' bonds traded up after the call with analysts.

Ms. Blackburn and Mr. Becker presented the rest of their information, and Mr. Masten asked if there was a motion.

> **Ms. Brookman moved, on behalf of the Private Markets Committee, that the Board approve a recommendation to invest up to $200 million, plus fees and expenses, in First Reserve Fund X, L.P., subject to final negotiation of terms and conditions. Mr. McElligott seconded.**

Mr. Charles said that he had made the motion to approve the investment at the Private Markets Committee meeting subject to acceptable explanations of the audit and the IRR. He said he is still concerned that the Board has not received the audited financial statements to review.

Treasurer Murphy thanked Mr. Dear and Mr. Bruebaker for following up in a meeting with additional information in response to his concerns about First Reserve. He said that he would vote against the motion because he would prefer to wait and review the audited financial statements. Mr. Seely spoke in favor of the motion saying he is comfortable with the information presented on Dresser. He said the merits and the risks of the investment in the First Reserve opportunity are well laid out, and he did not feel that deferring the decision in order to receive more information would be useful. Mr. Seely pointed out that there generally are pending issues with underlying portfolio companies in the area of private equity. In response to a question from Mr. Trause, Mr. Ruggels said that, if the Board chose to reach a decision in December rather than today, he did not believe there would be a loss in our allocation.

> **Mr. Masten called the roll. The motion carried with six ayes and three nays. Mr. Charles, Treasurer Murphy, and Mr. Scott voted no. Senator Zarelli, Mr. Gorton, Ms. Brookman, Mr. Masten, Mr. McElligott, and Mr. Trause voted yes.**

**EXECUTIVE STAFF'S REPORT - CONTINUED**
**Monthly Investment Reports**
Mr. Bruebaker gave the asset allocation report for the month of October. The Wilshire 5000 shows the performance of 16.5 percent for the second quarter, 7.2 percent for the third quarter, and 4.8 percent for the current quarter through November 18, 2003. The Wilshire outperformed the Russell for the month and the year ended October 31, 2003. In domestic markets, value outperformed growth slightly and small cap continues to be the place to be.

It continues to be a great year in developed markets. Emerging markets are also having a great year; 139.4 percent for Venezuela is clearly not sustainable, but nice to see. For the international equities, the weak dollar is benefiting the return back to us in U.S. dollars.

For the Lehman Universal, there have been phenomenal returns in both corporate high yield as well as emerging markets. We are underweight the index for corporate high yield, but we are overweight within the emerging markets. In the fixed income capital environment, the yield curve shifted upward and that's what caused the losses for longer treasuries. Assets under management were at $53.9 billion, up $1 billion from the previous month.

The CTF return of 2.9 percent is a phenomenal return for the month. As of October 31, the total CTF is at $40.5 billion, up $1 billion. We are within the adopted policy ranges within every individual asset class.

[The board took a break from 12:32 to 12:46 p.m.]
[Mr. McElligott and Mr. Nakahara left at 12:45 p.m.]

There being no further business to come before the Board, the meeting adjourned at 12:45 p.m.

**PORTFOLIO STRATEGY PRESENTATION: SOLVING THE INVESTOR'S PROBLEM**
Dr. Kevin Kneafsey with Barclays Global Investors gave a presentation on portfolio strategy. Dr. Kneafsey outlined the investor's problem – how much needs to be saved and how it should be invested such that there is a sufficiently high probability of having enough money to accomplish a goal some time in the future. He discussed the current solution and then an alternative way to solve the problem.

[Senator Zarelli left at 1:26 p.m.] [Mr. Trause left at 1:37 p.m.]

George Masten

George Masten
Chair

ATTEST

Joseph A. Dear

Joseph A. Dear
Executive Director