WASHINGTON STATE INVESTMENT BOARD

Board Meeting Minutes
February 19, 2004

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:	George Masten, Chair Debbie Brookman John Charles Glenn Gorton Charlie Kaminski Patrick McElligott, Vice-Chair Mike Murphy Bob Nakahara Jeff Seely Paul Trause Senator Joseph Zarelli
Absent:	Jeff Hanna John Magnuson Dave Scott Representative Helen Sommers
Also Present:	Joe Dear, Executive Director Gary Bruebaker, Chief Investment Officer Sue Hedrick, Executive Assistant 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 – January 15, 2004

> **Mr. McElligott moved to adopt the Board minutes of January 15, 2004. Mr. Charles seconded. The motion carried unanimously.**

PUBLIC COMMENT
There was no public comment.

QUARTERLY PERFORMANCE REPORTS
Commingled Trust Fund
Mr. Bruebaker provided the quarterly performance reports for the quarter ended December 31, 2003. This information is posted quarterly on the WSIB website (www.sib.wa.gov/).

The CTF assets are at $42.2 billion as of December 31, 2003, earning 7.74 percent for the quarter. The Savings Pool is at $556 million, earning 1.32 percent. The Bond Fund is at $329 million, earning 0.32 percent. The Short Horizon is at $28.9 million, earning 4.11 percent. The Mid-Horizon is at $84.6 million, earning 7.41 percent. The Long-Horizon is at $69.8 million, earning 10.9 percent for the quarter.

The total for the Labor and Industries (L&I) funds is at $9.4 billion. The Accident Fund earned 1.68 percent and the Medical Aid Fund earned 3.40 percent for the quarter. The Pension Reserve Fund lost 0.33 percent and the Supplemental Pension Fund lost .067 percent for the quarter. Total assets for the Permanent Funds are at $719 million, down $6.5 million. The GET Portfolio is at $326 million, up $38.5 million. The DDEF State Funds are up $117,000, and the DDEF Private Funds are at $518,000, up $208,000 from the previous quarter.

Private Equity – Pacific Corporate Group Report

Tom Ruggels, senior investment officer for private equity, introduced Tara Blackburn and Eric Becker from Pacific Corporate Group who reported on the private equity portfolio performance for the quarter ended September 30, 2003. They provided a summary of portfolio activity and a market review.

Mr. Becker said that contributions totaled $163 million, an increase of 75 percent over the second quarter. Distributions totaled $275 million, an increase of 24 percent over the second quarter. The combination of contributions and distributions during the quarter resulted in a positive cash flow of $112 million, compared to $128 million in the previous quarter. The portfolio appreciated by $227 million compared to $315 million in the previous quarter. The quarterly internal rate of return (IRR) was 4.1 percent, which increased the inception to-date IRR from 13 percent to 13.1 percent.

The KKR portfolio IRR increased from 16.4 to 16.5 percent. Contributions were $13 million, distributions were $64 million, and the portfolio appreciated by $95 million during the quarter. The LP portfolio IRR increased from 7.3 to 7.5 percent. Contributions were $150 million, distributions were $210 million, and the portfolio appreciated by $132 million. Unfunded commitments are at $1.6 billion for the KKR portfolio and $3.4 billion for the LP portfolio.

Mr. Becker reported on the performance of the KKR portfolio and the LP portfolio compared to S&P 500. Over the last quarter, the KKR portfolio posted a 6.8 percent return and the LP portfolio posted a 3.2 percent return compared to the S&P 500, which posted a 2.6 percent return. Over the ten-year horizon, the KKR portfolio posted a 17.4 percent return and the LP portfolio posted an 8.2 percent return compared to the S&P 500, which posted a 10 percent return.

Looking at performance by sub-sector, large corporate finance performed the best with an 8.3 percent return for the quarter, followed by mezzanine with a 3.3 percent return. Small/medium corporate finance and other lagged during the quarter with slightly negative returns.

Sub-sector allocations were generally in line with the targets. The portfolio's largest industry exposures were in manufacturing at 22 percent, technology at 14 percent, and financial services at 12 percent.

Real Estate
Steve Draper, senior investment officer for real estate, commented briefly on the real estate portfolio. He said that Hometown America's acquisition of Chateau Communities was completed shortly after the end of the third quarter. Hometown had a three-year plan to divest certain properties that they thought were not core holdings. The plan has been implemented, and after four months, is nearly 90 percent complete. The sale of 80 properties will result in $231 million of net proceeds to the Board within the next few days, and approximately two weeks after that, another $45 million from the sale of 11 properties will be returned. Mr. Charles complemented Mr. Draper on the success of this undertaking to-date.

Mr. Draper introduced Michael Humphrey who reported on performance of the real estate portfolio through September 30, 2003. The total current market value of the portfolio is $3.6 billion. Including the Hometown investment made in the fourth quarter, the actual value is now $4.4 billion. It will reduce to $4.2 billion with the completion of the aforementioned sale. The net real estate returns are in the 11 percent range for the one, three and five-year period, which is a strong performance. Real returns have been in the high 8-9 percent range. Historically, real returns have run in the 5 percent range.

The top 10 investments comprise 75 percent of the portfolio. Principal Enterprise Capital has produced a strong performance. Their one-year return was 35 percent, and the income return was 9+ percent. Lone Star III and IV have done well. The illiquidity in the Asian markets, primarily Japan has continued and they have continued to be successful in taking advantage of it. The one-return for Lone Star III was 30+ percent. PacTrust focuses on office and industrial facilities, which has worked well. Their income returns have been strong, in the 11-12 percent range over the one and three-year periods. Union Square produced a 12 percent income return this past year. Some of the smaller investments, such as CPA, a Mexican industrial platform, also have done well. WA Holdings had a one-year return of 20+ percent. Of concerns has been Olympia Properties, which has had a –6 percent appreciation for the year. They've seen a lot of vacancies in the Midwest office and industrial markets in which they are invested. Also of concern is Hawthorne Timber, which has been written down about 6 percent over the last year. EuroInvest has also underperformed.

In the benchmark comparison analysis, we have outperformed over the quarter, one, three and five-year periods. Mr. Humphrey said that he is working with staff on updating the classifications of risk returns. Real estate has been somewhat impacted by the economic recovery. GDP improved to 7.2 percent in the third quarter; however, the recovery has been muted by the fact that job creation has been so low. Real estate lags the performance of equities, so it will to take some time for job creation to occur. Office and industrial are expected to continue to be static, but retail will continue to do well.

AUDIT COMMITTEE REPORT
Fiscal Year 2003 State Audit Report
Mr. Masten said he had one item before Mr. Charles began his report. The Audit Committee is short one board member.

Mr. Masten moved that Treasurer Murphy be appointed to the Audit Committee. Mr. Charles seconded. The motion passed unanimously.

Mr. Charles reported that the committee met on February 2, 2004. The first item was a report from the State Auditor on the WSIB's fiscal year 2003 state audit. Mr. Steve Wendling from the State Auditor's Office reported that the WSIB received another clean audit.

On behalf of the Audit Committee, Mr. Charles moved that the FY 2003 State Audit Report be accepted. Treasurer Murphy seconded. The motion passed unanimously.

Internal Audit 2004-03 WSIB Performance Reporting

Mr. Charles said the next item was the internal audit on the WSIB Performance Reporting by the internal auditor, Beth Vandehey. Mr. Charles said the Audit Committee recommended that the Board accept Internal Audit Report 2004-03.

Mr. Charles moved that the 2004-03 Performance Reporting Audit be accepted. Mr. McElligott seconded. The motion passed unanimously.

Policy Revision 1.00.190 – Internal Audit Charter

Mr. Charles moved the Audit Committee's recommendation that the Board adopt Policy 1.00.190 as modified. Mr. Murphy seconded. The motion passed unanimously.

Mr. Charles said the committee then discussed nonvoting member appointments. At the request of the committee, staff created a list of identified areas of expertise of nonvoting members, WSIB staff, investment partners and consultants to determine if there are any gaps. Mr. Charles distributed this to the Board. He said the committee reviewed the list and discussed the process for nominating nonvoting members to the board. The process for recruiting and nominating candidates was put on the WSIB website. Two positions are up for appointment or reappointment. The Audit Committee will be reviewing potential candidates at its next meeting in May. The two members with expired terms have indicated they are interested in continuing to serve on the board.

[The board took a break at 10:37 a.m. and reconvened at 10:50 a.m.]

Mr. Charles reported that 60 Minutes had a broadcast, "Doing Business with the Enemy," on global security and public pension funds that are unwittingly investing in major companies allegedly involved in illegal business activities with countries that support and underwrite terrorism. The story prompted a discussion at the last Employee Retirement Benefits Board meeting and the Audit Committee meeting earlier this month. The Audit Committee directed staff to draft a letter of concern to the President and other appropriate authorities asking them to launch an investigation. Mr. Charles distributed the draft letter, indicating he felt the issue should be brought to the Board for discussion.

Mr. Dear said the active equity managers have been asked what their policies are to screen companies, and have received responses from all but one. And it was learned that the U.S.

government in the Office of Foreign Asset Control (OFAC) within the Treasury Department maintains a list of companies or individuals with whom U.S. persons are prohibited from doing business. In addition, the U.S. State Department maintains a list of countries that the U.S. deems to be supporting international terrorism. Mr. Dear cautioned the Board that taking action based on subjective information could be risky. He suggested that any action taken by the Board should be based on a finding by the U.S. government.

A discussion ensued on whether the Board wants to take any sort of action, and if so, who a letter would be sent to.

> **Mr. Murphy moved that a communication be sent to the President, the Secretary of the U.S. Treasury Department, the Securities and Exchange Commission, the New York Stock Exchange and the Washington State Congressional delegation. Mr. Masten seconded.**

Mr. Trause cautioned against doing anything merely in response to a 60 Minutes program. He suggested instead that the Board call upon the State Department to supplement its country list with a company list, as suggested by the Council of Institutional Investors that would disclose those companies that are acting in violation of U.S. law.

[Senator Zarelli arrived at 11:05 a.m.]

Treasurer Murphy gave an explanation of why he made the motion. He suggested that, with allegations that certain companies are doing business in countries in violation of federal law, and with the possibility that the WSIB might have investments in these companies; the Board has a responsibility to ask that these allegations be looked into.

Senator Zarelli suggested the issue be referred to the Public Markets Committee to look at the companies the WSIB does business with, devise a policy on the matter and address it internally. Mr. McElligott spoke in favor of the motion. Mr. Trause spoke against the motion.

> **The motion failed.**

> **Mr. Trause moved that the Board refer this matter to the Public Markets Committee for review and recommended action to the Board. Senator Zarelli seconded. The motion passed unanimously.**

PUBLIC MARKETS COMMITTEE REPORT

International Developed Markets Equity Enhanced Index Investment Manager Finalist Selection

Mr. Gorton reported that, in July 2003, the Board approved changes to the structure of the retirement fund's international equity program. At the Public Markets Committee on Feb 3, 2004, the committee interviewed five firms as potential managers for the international developed markets equity enhanced index mandate.

The firms interviewed were:

- Barclays Global Investors
- DSI International Management, Inc.
- Goldman Sachs Asset Management
- Merrill Lynch Investment Managers, and
- Northern Trust Global Investments

After the interviews, staff and Callan Associates (Callan) independently indicated their preferences for the top two firms. The committee had a good in-depth discussion of the pros and cons of each of the firms as well as discussions of various combinations. Staff and Callan also discussed the allocation to international developed markets equity enhanced indexing and recommended that it be 50 percent of the total international developed markets equity index allocation, with which the committee agreed.

The committee then, by consensus, selected Barclays Global Investors, and Goldman Sachs Asset Management for the WSIB international developed markets equity enhanced index mandate, subject to continuing due diligence and successful negotiation of acceptable terms and conditions.

Site visits are currently underway and transition strategies will be developed with one of the WSIB's transition managers.

> **Mr. Gorton moved that the Board approve the Public Markets Committee's consensus recommendation of employing 50 percent of the total international developed markets passive equity allocation in an enhanced index strategy, with Goldman Sachs Asset Management and Barclays Global Investors, N.A. as the apparently successful offerors, subject to continued due diligence and successful negotiation of terms and conditions. Mr. McElligott seconded. The motion passed unanimously.**

International Developed Markets Equity Index Investment Finalist Selection

Mr. Gorton said that the Public Markets Committee also interviewed two firms as potential managers for the international developed markets equity index mandate. The firms interviewed were Barclays Global Investors and State Street Global Advisors.

After the interviews, staff and Callan Associates independently indicated their preferences for the top firm and discussed the merits of each firm with the Committee. The Committee then selected State Street Global Advisors for the WSIB international developed markets equity index mandate, subject to continuing due diligence and successful negotiation of acceptable terms and conditions.

A site visit has already taken place and there will be no transition necessary if SSgA, the current international developed markets equity index manager, is approved by the Board.

Mr. Gorton moved that the Board approve the Public Markets Committee's recommendation of State Street Global Advisors as the apparently successful offeror for the international developed markets equity index investment mandate, subject to continued due diligence and successful negotiation of terms and conditions. Mr. Trause seconded. The motion passed unanimously.

Mr. Gorton said that staff also presented a quarterly watchlist report for information only and did not recommend any changes at this time. Mr. Bruebaker told the committee that the internally-managed Bond Fund and Horizon Funds had been placed on watchlist.

PRIVATE MARKETS COMMITTEE REPORT

Private Equity Benchmark Review

Ms. Brookman said the Private Markets Committee met on February 5, 2004. Committee members discussed a number of issues including the private equity benchmark. Staff presented their study that included the definition of a "good" benchmark and why private equity as an asset class does not have one. Staff then related three different types of benchmarks peers were using, including absolute return, peer universes, and more commonly passive index plus an absolute or premium return. The committee then discussed some of the pros and cons of each.

Staff discussed the premium private equity could be expected to earn over public markets in the future. Staff's recommendation was to change the current benchmark for the S&P 500 plus 400 to 600 basis points to the S&P 500 plus 400 basis points, eliminating the range.

The committee recommended a change to the benchmark to the S&P 500 plus 500 basis points. The committee felt this benchmark provided a nice average of the current range and sets our expectations high for private equity.

Ms. Brookman moved that the Board approve the Private Markets Committee's recommendation to change the private equity benchmark to the S&P 500 time weighted total return plus 500 basis points, and allow staff to update the affected policy to reflect the change. Treasurer Murphy seconded. The motion passed unanimously.

Private Equity – Essex Woodlands Health Ventures VI, L.P. Investment Recommendation

Ms. Brookman said the Private Markets Committee recommends an investment of up to $40 million in Essex Woodlands Health Ventures Fund VI, L.P. This is a $400 million venture capital fund that will focus exclusively on investments within the healthcare industry.

The WSIB is an existing investor with Essex Woodlands, having committed $10 million to Fund IV through Pathway Capital Management in 1998, and a total of $50 million to Fund V in 2000. The company has a strong management team with significant healthcare investing and operating experience and expertise. Since 1985, they've generated a net IRR of 12.2% on $308 million invested since 1985.

The investment strategy, while focused solely on the healthcare industry, is diversified across six industry sub-sectors, and balances the higher risk and longer holding periods of early stage investments with the lower risk/shorter hold of later stage deals. This investment is an excellent fit within the private equity portfolio and the WSIB's experience as an investor in two prior funds has been positive.

> **Ms. Brookman moved that the Board approve the Private Markets Committee's recommendation to invest up to $40 million, plus fees and expenses, in Essex Woodlands Health Ventures Fund VI, L.P., subject to final negotiation of terms and conditions. Mr. McElligott seconded.**

Mr. Charles said he was advised to disclose that he is a founding investor in Cell Therapeutics, which is a significant investment of Essex Woodland Health Ventures Fund IV, L.P. He said, however, it does not preclude him from voting.

> **The motion passed unanimously.**

Ms. Brookman said the committee also received a report on the private equity annual plan provided by staff and Pacific Corporate Group. Our objective is to maintain adequate diversification within our private equity portfolio by vintage year, sub-sector and manager, with an ultimate goal of enhancing the quality and performance of the portfolio while moving toward our asset allocation target for private equity of 17 percent.

It is anticipated that total commitments for 2004 will be in the range of $1 - $1.2 billion, which is significantly higher than the commitment pace during the last two years – approximately double. The increased pace for 2004 is primarily due to increased capacity, resulting from a significant increase in our total retirement fund assets and significant volume of distributions, in excess of $1 billion received in 2003 from liquidated private equity investments.

The committee also received a report on the annual real estate plan. Michael Humphrey of Courtland Partners provided the overview along with his views about current trends and conditions, emphasizing that capital flows into real estate have been exceptionally high recently, and that the trend is expected to continue.

Staff also presented an overview of the WSIB real estate portfolio, including a preview of the recommended future direction of the portfolio. The success we've had using the real estate operating company investment approach was highlighted, and staff indicated that a substantial component of future recommendations to the Board would likely come from this strategy. Staff also suggested that domestic growth markets and non-U.S. exposure would continue to be emphasized going forward, and that efforts would be made to decrease the WSIB's exposure to chronically underperforming partnerships.

Other Items

Mr. Masten indicated that there is a vacancy on the Public Markets Committee.

Mr. Masten moved that he be appointed to the Public Markets Committee. Mr. Charles seconded. The motion passed unanimously.

[The board took a break at 11:50 a.m. and reconvened at 12:05 p.m.]

EXECUTIVE STAFF'S REPORT

Executive Director's Report

Mr. Dear presented his report for February. Mr. Dear distributed the WSIB's annual report for 2003. There was a significant cost savings in producing the report. Last year's hard-bound report cost $15.63 and this year's cost $3.90. The new real estate investment officer will start on March 22, 2004.

All of the bills that dealt directly with the WSIB died in cut-off on February 17, 2004, including a bill sponsored by Representative Velma Veloria that sought to address her concerns about the ability of minority-owned firms to get access to capital. Mr. Dear said that he and other WSIB staff will meet with her, along with representatives of minority businesses, the Washington Technology Center, the Seattle Chamber of Commerce and other legislators to talk about practical steps that can be taken short of direct legislative intervention in the board's investment policy decision-making.

MONTHLY INVESTMENT REPORTS

Mr. Bruebaker presented the monthly asset allocation report as of January 31, 2004.

The Wilshire 5000 is up for the quarter 4.7 percent. It continues to be a good year for international investments. In fixed income, the emerging markets and the corporate high yield continue to dominate in that asset class. Assets under management are at $56.5 billion, up $683 million. The return, fiscal year to-date, is at 13 percent. For the month, we have a return of 1.4 percent. The CTF is at almost $42.6 billion, up $487 million from the previous month. All asset classes are within the long-term policy ranges.

ADMINISTRATIVE COMMITTEE REPORT

Board Travel and Education Policies

Mr. Masten said the Administrative Committee proposed that Policy 2.00.200 be amended and leave the other policies as is. The committee's revisions were specifically that, on the second page of the policy, section 8 is amended to read, "Attendance by board members at any conference shall require approval by the Board Chair in advance." Section 9 is amended to read, "The Board shall establish a list of *recommended* conferences."

Mr. Masten moved the Administrative Committee's recommendation to accept Policy 2.00.200 as amended. Mr. McElligott seconded. The motion passed with Treasurer Murphy voting no.

ASSISTANT ATTORNEY GENERAL'S REPORT

Mr. Silver reported on the WorldCom case. We appealed the federal district court ruling which removed our case from state to federal court. The appeals court suspended the deadline for choosing to opt out of the federal class action until the removal issue is decided. Mr. Silver said that the appellate court may rule that removal was improper, which would put us back in state court

prosecuting our own case, or it can agree with the district court and decide that consolidation with the class action was appropriate. Then the board would need to decide whether to join the class action or continue with its separate case.

ADMINISTRATIVE COMMITTEE REPORT - continued
Executive Director's Evaluation
Mr. Masten called the Board into executive session at 12:33 p.m. for the purpose of reviewing and discussing the performance of the Washington State Investment Board's Executive Director. He estimated that the executive session would last until approximately 12:45 p.m., and after completion of the executive session, the Board will resume its regular session and may take action that might arise from the executive session or just adjourn.

[The executive session concluded at 12:47 p.m. and the open session reconvened immediately thereafter].

There being no further business to come before the Board, the meeting adjourned at 12:48 p.m.

George Masten
Chair

ATTEST

Joseph A. Dear
Executive Director