WASHINGTON STATE INVESTMENT BOARD

Board Meeting Minutes
May 20, 2004

The Washington State Investment Board met in open public session at 9:33 A.M. in the boardroom at 2100 Evergreen Park Drive SW, Olympia, Washington.

Present:	George Masten, Chair Patrick McElligott, Vice-Chair Debbie Brookman Glenn Gorton Jeff Hanna Charlie Kaminski Mike Murphy Bob Nakahara Dave Scott Jeff Seely Representative Helen Sommers Paul Trause
Absent:	John Charles John Magnuson Senator Joseph Zarelli
Also Present:	Joe Dear, Executive Director Gary Bruebaker, Chief Investment Officer Steve Draper, Senior Investment Officer-Real Estate Tom Ruggels, Senior Investment Officer-Private Equity Tom Bosworth, Investment Officer-Fixed Income Diana Will, Investment Officer-Asset Allocation Kristi Walters, Executive Assistant Paul Silver, Assistant Attorney General
	Eric Becker, Pacific Corporate Group Scott Daniels, Conning Asset Management Rob Painter, Conning Asset Management Richard G. Cline, Jr., Hometown America Owen D. Thomas, Morgan Stanley Real Estate Michael W. Luecht, ML Realty Partners Thomas F. Darden, Cherokee

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

Chair Masten called the meeting to order and roll call was taken.

ADOPTION OF MINUTES - APRIL 15, 2004

Mr. McElligott moved to adopt the Board minutes of April 15, 2004. Mr. Trause seconded and the motion carried unanimously.

PUBLIC COMMENT

There was no public comment.

QUARTERLY PERFORMANCE REPORTS

Mr. Brubaker provided the quarterly reports for the commingled trust fund (CTF), defined contribution plans, daily priced investment options, Labor and Industries' funds, and permanent and other trust funds for the period ended March 31, 2004.

Commingled Trust Fund

The CTF was at $43.6 billion, up $1.5 billion for the quarter. U.S. equity was at $14.4 billion, international equity was at $7.3 billion, fixed income was at $11.1 billion, private equity was at $6.1 billion, and real estate was at $4.6 billion.

Defined Contribution Plans

For the quarter, the Teachers Retirement System Plan 3 was at $2.1 billion, up $107 million; School Employees Retirement System Plan 3 was at $613 million, up $27 million; and Public Employees Retirement System Plan 3 was at $807 million, up $30 million. The Deferred Compensation Program was at almost $1.7 billion, up $50 million; and the Judicial Retirement Account was at $12.5 million, up $368,509.

Daily Priced Investment Options

The Savings Pool was at $557.8 million, up $1.8 million for the quarter; and the Bond Fund was at $338.8 million, up $9.4 million. For the Horizon Funds, the Short-Horizon was at $31.7 million, up $2.8 million; Mid-Horizon was at $94 million, up $9.3 million; and the Long-Horizon was at $78 million, up $8.1 million for the quarter.

Labor and Industries' Funds

The Labor and Industries' Funds were at $9.7 billion, up $300 million for the quarter. The Accident Fund returned 4.39 percent, the Medical Aid Fund returned 2.78 percent, the Pension Reserve Fund returned 4.69 percent, and non-cash portion of the Supplemental Pension Fund returned 1.94 percent for the quarter.

Permanent and Other Trust Funds

Total assets for the Permanent Funds were at $736.2 million, up $16.7 million for the quarter. The Guaranteed Education Tuition Portfolio was at $373.2 million, up $47 million. For the Developmental Disabilities Endowment Funds, the state portfolio was at $6.6 million, up $200,000 and private funds portfolio was at $718,000, up $200,000 for the quarter.

Private Equity
Mr. Ruggels introduced Eric Becker of Pacific Corporate Group (PCG), the Board's private equity consultant. Mr. Becker provided the private equity funds quarterly report for the period ended December 31, 2003. Commitments authorized during the quarter were Texas Pacific Group (TPG) IV, Silver Lake II, Endeavor IV, First Reserve X, and a secondary investment in Mobius VI, totaling $558 million. TPG, First Reserve, and Mobius closed during the quarter totaling $383 million. Authorized commitments totaled $683 million and closed commitments totaled $583 million.

Activity for the fourth quarter included contributions totaling $307 million, an increase of 88 percent from the previous quarter. Distributions totaled $451 million, an increase of 64 percent from the third quarter. The combination of contributions and distributions during 2003 resulted in net cash in-flow of $183 million, compared to net cash outflow of $646 million during 2002. The portfolio appreciated by $495 million, compared to $227 million in the third quarter. The quarterly internal rate of return (IRR) was 8.7 percent, which increased the inception to-date IRR from 13.1 to 13.4 percent. Mr. Becker provided a market activity review of venture capital and buyout fundraising and capital invested, primary and secondary equity offerings, and M&A activity.

The KKR portfolio IRR remained unchanged at 16.5 percent. Contributions were $99 million, distributions were $187 million, and the portfolio appreciated by $125 million during the quarter. The LP portfolio IRR increased from 7.5 to 8.6 percent. Contributions were $208 million, distributions were $263 million, and the portfolio appreciated by $369 million. Unfunded commitments are at $1.5 billion for the KKR portfolio and $3.5 billion for the LP portfolio.

Mr. Becker reported on the performance of the KKR portfolio and the LP portfolio compared to the S&P 500. For the quarter, the KKR and LP portfolios both posted 8.7 percent returns. For the ten-year period, the KKR portfolio posted a 14.2 percent return and the LP portfolio posted a 9.9 percent.

Looking at performance by sub-sector, Mr. Becker said that a new category was added to account for direct secondaries. International, large corporate finance and distressed performed the best during the quarter with 14.5, 9.6, and 8.3 percent returns respectively. Sub-sector allocations were within targeted parameters. The portfolio's largest industry exposures were in manufacturing at 22 percent, technology at 15 percent, and financial services at 11 percent.

Mr. Kaminski noted the difference in data points between PCG and staff's reports. Mr. Becker explained methodologies between the dollar-weighted IRR calculation used by PCG and the time-weighted valuation used by staff, both of which are appropriate and consistent with industry standards. Mr. Kaminski requested that future performance reports are footnoted with this information.

Real Estate
Mr. Draper provided the real estate quarterly performance report from Courtland Partners for the period ended December 31, 2003. The real estate portfolio was $4.5 billion. Real estate represented 10.8 percent of CTF assets. For the one, three, and five-year net returns were 10.6, 10.8, and 11.3 percent respectively. The real estate performance surpassed the NCREIF index over

the quarter, one, three, and five-year periods. Significant events included Hometown America's purchase of Chateau Communities, another strong quarter for Principal Enterprise Capital, and Lone Star III's reporting of significant unrealized appreciation involving Tokyo Star Bank (Japan) and Star Tower (Korea). Hawthorne Timber wrote down property values to reflect current market conditions. Mr. Hanna asked how high lumber prices and declining timber land values could occur simultaneously. Mr. Draper explained that log prices have not risen as quickly as lumber prices, and the effect of higher lumber values may be reflected in future quarters, although the Hawthorne properties are mostly comprised of redwood and have different market and environmental dynamics. EuroInvest wrote down properties in Germany, Poland, and the United Kingdom. Mr. Draper reported that Prudential is selling PRICOA, the general partner of EuroInvest, to the existing management team. The general partnership ownership will change but the people overseeing the investment will remain the same. Staff is watching the situation. PAC/SIB wrote down values by $18 million due to continued vacancies in tech markets. Those markets appear to be starting an upturn. He said that the Hometown/Chateau transaction substantially altered portfolio diversification. From the third to fourth quarters, investments in office property moved from 31.4 percent to 24.4 percent, residential changed from 14.4 to 26.4 percent, and retail now falls slightly below the guidelines. The geographic distribution of investments also changed from 18.7 to 24.0 percent in the south region. Foreign exposure is slightly above the guidelines, and the portfolio also continues to be heavily weighted to the west and south. Mr. Draper noted that the west, south, and foreign regions of the portfolio will likely continue to grow.

[The Board recessed at 10:37 A.M. and reconvened at 10:45 A.M.]

CAPITAL MARKET ASSUMPTIONS

Ms. Will introduced staff's proposed capital markets assumptions, which, if approved, would be used in 2004 asset allocation studies. She said that strategic asset allocation is one of the Board's most important decisions. Capital market assumptions are a key ingredient of strategic asset allocations. They combine three characteristics of each asset class in the portfolio: the expected return, the volatility of the return (standard deviation), and the relationship of that asset to other assets (correlations). Ms. Will said that planned asset allocation studies for the year include the Horizon Funds and defined contribution daily priced investments options. Updated assumptions would be developed next year for the CTF during the retirement system study. Staff developed the assumptions by reviewing and comparing assumptions from the Board's pool of consultants. The comparison showed that an average of the consultant's assumptions would be a good fit for public markets, but the components of the private equity and real estate portfolios differed from the consultants and further steps were required to reach the proposed assumptions.

A discussion ensued regarding whether there is an optimal mix of correlations and deviations, the consultants' assumptions relating to Treasury Inflation Protected Securities (TIPS), the potential affect a federal funds' rate increase could have on the assumptions, and what diversifies risk.

[Mr. Scott was in attendance at 10:51 A.M.]

Mr. Murphy moved that the Board adopt the 2004 WSIB capital market return, risk, and correlation assumptions as presented. Mr. McElligott seconded and the motion passed unanimously.

LABOR & INDUSTRIES' ASSET LIABILITY STUDY REPORT AND RELATED POICY REVISION

Mr. Bruebaker introduced Scott Daniels and Rob Painter from Conning Asset Management. Mr. Daniels said that Conning worked closely with Labor & Industries (L&I) staff in its asset liability study to define objectives, build and test a financial model, develop and test alternative strategies, and to reach consensus with L&I and WSIB on the recommended investment strategy. He explained the current investment strategy's duration target ranges, equity asset allocation, and how changes in the balance sheet caused issues for the portfolio. Mr. Painter described Conning's Dynamic Financial Analysis (DFA) model, including the benefits and strategic questions that can be evaluated by using it. He said that Conning worked with L&I to define their risk tolerance, determine their primary and secondary objectives, and define key risks. They studied historical data, built assumptions for key variables, and modeled L&I's balance sheet and insurance operations. Feedback on the modeling process was obtained from L&I and WSIB staff. General observations were that L&I's current investment strategy has been reasonable and insurance risks far outweigh its investment risks.

Mr. Painter said that recommendations are for the Medical Aid Fund and Accident & Pension Reserve Fund combined. The key decision making factors for the fixed income duration were the level of investment income generation from the bond portfolio, long-term economic value, risk, and other factors including net operating cash flow and the contingency reserve. Conning recommends an extension in the duration target for the Medical Aid Fund from 4 to 6.

A discussion ensued regarding timing for implementation, what assets to use to move the Medical Aid Fund duration from 4 to 6, the importance of the yield and how it effects L&I rates, and the potential for L&I selling its liabilities.

Conning recommends a duration target of 9 for the Accident Fund and Pension Reserve Funds. The equity allocation recommendation is 30 percent for the Medical Aid Fund and 10 percent for the Accident and Pension Reserve Funds, both of which minimize the probability of an unacceptable rate change and are not significantly different from the current allocation.

Mr. Daniels explained the practical implications of implementing the recommended strategy. He said that the fixed income duration targets will remain stable from quarter to quarter, extending the duration of the bonds in the Medical Aid Fund can be done over time, and the rebalancing strategy of the target plus or minus 20 percent has worked well and should be maintained.

Mr. Daniels said that the Supplemental Pension Reserve Fund was not included in the modeling process because it is a small, pay-as-you go fund with a different risk profile. It is invested in cash and short duration fixed income instruments. Conning recommends shortening the duration target range from 1.75 to 2.25 for liquidity needs. Conning also recommends that the duration target apply only to the non-cash portfolio of the portfolio, that the CMI be revised to reflect the new duration target, and that L&I and WSIB staff review the split between cash and non-cash portions of the portfolio on a quarterly basis.

Ms. Will presented a revised Labor and Industries' Insurance funds policy incorporating the Conning recommendations.

> **Mr. Trause moved that the Board approve Conning Asset Management's recommendations to the Labor and Industries' strategic asset allocation, adopt the revisions to the Labor and Industries' Insurance Funds Policy 2.20.100, and instruct staff to implement the changes. Mr. McElligott seconded the motion.**
>
> **The above motion passed with Mr. Murphy voting no.**

ADMINISTRATIVE COMMITTEE REPORT

Code of Conduct Policy 2.00.150 Adoption

Chair Masten said that the Administrative Committee reviewed staff revisions to the draft Code of Conduct policy that Cortex Applied Research, Inc. had recommended to the Board at its July 2003 workshop.

> **Chair Masten moved that the Board adopt the Code of Conduct Policy 2.00.150. Mr. Trause seconded the motion.**

Mr. Murphy noted the blue-lined policy draft with revisions he recommends on page two of the policy.

> **Mr. Murphy moved to amend the motion by adopting the Code of Conduct Policy 2.00.150 with restated language on page two. Mr. McElligott seconded and the motion, as amended, passed unanimously.**

[The Board recessed at 12:15 P.M. and reconvened in open session at 12:36 P.M.]
[Mr. Seely was no longer in attendance at 12:36 P.M.]

Chair Masten said that the Administrative Committee met earlier in the morning to discuss potential budget items. The Committee will have a special meeting in July and bring the budget before the Board at its July 22 meeting. There were no other Committee items to report.

AUDIT COMMITTEE REPORT

Internal Auditor Report – Fiscal Year 2004-05 Audit Plan

Chair Masten reported that the internal auditor presented the Fiscal Year 2004-05 Audit Plan to the Audit Committee at its May 4 meeting. This included audit objectives, risk assessment planning, and other work projects for the coming fiscal year. The areas selected for audit review are the real estate unit, the new straight-through processing and fixed income compliance monitoring system, the domestic passive manager, and the international active managers.

Chair Masten moved that the Board accept the Fiscal Year 2004-05 Audit Plan. Mr. Murphy seconded and the motion passed unanimously.

Chair Masten said that the Committee also discussed nonvoting Board member selection. Three resumes were reviewed. The Committee decided to conduct interviews on June 1 from 2:00 to 5:00 P.M. All Board members are invited to attend. Chair Masten said that interviews would be conducted for four applicants, including Mr. Magnuson, and Mr. Kaminski. There were no other Committee items to report.

PUBLIC MARKETS COMMITTEE REPORT

Preventing Inadvertent Investments in Companies Doing Business with Terrorist-supporting Nations

Mr. Gorton reported that the Public Markets Committee met on May 4. The Committee reviewed the issues with regard to preventing inadvertent investments in companies doing business with terrorist-supporting nations. It was determined that public equity managers do not knowingly invest in companies that are in violation of U.S. law or are illegally doing business with terrorist-supporting nations. Federal government efforts in this area were discussed, including legislation adopted in January 2003 which established a new Securities and Exchange Commission Office of Global Security Risk.

Mr. Gorton moved that the Board direct staff to continue to monitor the issues related to preventing inadvertent investments in companies doing business in terrorist-supporting nations, oversee managers, and work with others to assess effectiveness of existing and additional federal agency efforts. Mr. McElligott seconded the motion.

Mr. Murphy asked if all of the foreign managers were advised of this directive. Mr. Dear confirmed that staff has discussed this with managers and continues to do so. Mr. Murphy asked that staff communicate back to the managers that we will continue to monitor and that they should also.

The above motion passed unanimously.

Frank Russell Securities, Inc. Directed Brokerage Contract Extensions

Mr. Gorton reported that the Public Markets Committee considered the first extension to the Frank Russell Securities, Inc., contract which expires December 31, 2004. Frank Russell is doing a good job.

Mr. Gorton moved that the Board authorize the executive director to extend the contract with Frank Russell Securities, Inc. for one year through December 31, 2005. Mr. Trause seconded and the motion passed unanimously.

Mr. Gorton said that the Committee also heard fixed income and Horizon Fund annual reviews. The Committee also heard the quarterly watchlist report. The Fidelity overseas fund was removed from the watchlist due to improved performance. Nicholas-Applegate, RCM, and Putnam Investments were removed from watchlist since the Board has hired replacement firms as part of the international equity program review. The Bond Market Fund and the Horizon Funds were placed on the watchlist in February due to performance. As of the end of April, the performance of these funds shows signs of improvement. There were no other Committee items to report.

EXECUTIVE STAFF'S REPORT

Executive Director's Report

Mr. Dear presented his report for May. Mr. Scott asked him about a letter concerning a development in Denver managed by Cherokee Investment Partners. Mr. Dear said that staff had received a follow-up request from labor and community representatives asking for assistance from the WSIB to meet with Cherokee regarding the development. Cherokee is happy to accommodate the request.

Monthly Investment Report

Mr. Brubaker provided the CTF monthly investment report. U.S. equities were down 2.1 percent for April, but outperformed the benchmark by 24 basis points (bps) for the year . The international markets were down 2.9 percent for April, but outperformed the benchmark by 20 bps for the month. Fixed income lost 2.5 percent for April, but outperformed the Lehman Universal and Lehman Aggregate benchmarks by 6 and 10 bps respectively. CTF governments underperformed the index governments by 2 bps due mostly to TIPs during April. CTF credits outperformed by 6 bps due to security selection and shorter durations, and securitized underperformed by 5 bps for April. Private equity returned 6.9 percent for the month. Mr. Bruebaker provided the private equity draws and distributions for April. The Board's investment in Hellman and Friedman has not yet closed, but it appears the WSIB will only receive an allocation of $75 million of the $100 million approved. No investments closed in April. Real estate returned .6 percent for April.

ASSISTANT ATTORNEY GENERAL'S REPORT

Mr. Silver provided an update on the WorldCom class action. Citigroup has settled its potential liabilities to the class action by agreeing to pay $2.65 billion. Citigroup has set aside more than $6 billion in addition to address other liabilities including liabilities to independent actions outside of the class action. The settlement with the class benefits the WSIB only indirectly, since most of the WSIB's fixed income losses are not included in the claims of the class. The WSIB will continue with its separate class action. Citigroup has indicated that they will entertain negotiations with the Lerach firm which represents the WSIB. The appeal to the federal appellate court concerning the removal of the state case from state to federal court was approved. If there are no further changes, the case will be argued in federal court with discovery and depositions over the next several months. The case is set for trial in 2006.

[Mr. Nakahara, Mr. Murphy, and Representative Sommers were no longer in attendance at 12:56 P.M.]

REAL ESTATE EDUCATION SESSION

Mr. Draper introduced the education session. He provided an overview of the WSIB's real estate strategy. Panelists from leading real estate general partners including Rich Cline of Hometown America, Owen Thomas of Morgan Stanley Real Estate, Mike Luecht of ML Realty, and

Tom Darden of Cherokee Investment Partners introduced themselves to the Board. The panelists shared their insights on the strategies of their organizations, the current state of their particular market or strategy, and the risks in their investments and how those risks are mitigated. They also discussed the impact of surging institutional capital investments, return expectations, whether non-U.S. real estate investment matches the risk for a tax-exempt investor, how rising interest rates are affecting strategies, the impact China has on their business, and their views on what the WSIB should be concerned about in the current environment and what to look for when underwriting potential real estate relationships.

[Mr. McElligott was no longer in attendance at 1:57 P.M.]
[Mr. Trause was no longer in attendance at 2:52 P.M.]

There was no further business to come before the Board. The meeting adjourned at 2:56 P.M.

George Masten

George Masten
Chair

ATTEST

Joseph A. Dear

Joseph A. Dear
Executive Director