WASHINGTON STATE INVESTMENT BOARD

Board Meeting Minutes
September 16, 2004

The Washington State Investment Board met in open public session at 9:36 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 John Magnuson Bob Nakahara Dave Scott Jeff Seely Representative Helen Sommers Senator Joseph Zarelli
Absent:	John Charles Mike Murphy Paul Trause
Also Present:	Joe Dear, Executive Director Gary Bruebaker, Chief Investment Officer Kristi Walters, Executive Assistant Paul Silver, Assistant Attorney General Michael Humphrey, Courtland Partners Eric Becker, Pacific Corporate Group George Roberts, Kohlberg Kravis Roberts and Company Mike Michelson, Kohlberg Kravis Roberts and Company Mike Heale, Cost Effectiveness Measurement, Inc.

[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.

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 June 30, 2004.

Commingled Trust Fund

The CTF was at $43.3 billion, down $19 million for the quarter. U.S. equity was at $14.6 billion, up $200 million for quarter. International equity was at $7.3 billion, which is the same as last quarter. Fixed income was at $10.9 billion, private equity was at $6.2 billion, and real estate was at $4.1 billion.

Defined Contribution Plans

For the quarter, the Teachers Retirement System Plan 3 was at $2.2 billion, up $53.8 million; School Employees Retirement System Plan 3 was at $626.7 million, up $12.7 million; and Public Employees Retirement System Plan 3 was at $820 million, up $13 million. The Deferred Compensation Program was at almost $1.7 billion, up $41.9 million; and the Judicial Retirement Account was at $12.9 million, up $427,948 for the quarter.

For the quarter, the Bond Market Fund outperformed the index by 32 bps, the cash funds slightly underperformed by 2 bps, and the TAP Option outperformed by 73 bps for the quarter. The Long Horizon outperformed by 11 bps, Mid Horizon outperformed by 18 bps, and the Short Horizon outperformed by 17 bps. The Social Balanced Fund outperformed by 117 bps. The Equity Income Fund outperformed for the quarter by 75 bps, the Independence Fund outperformed by 69 bps, and the Growth Company Fund outperformed by 57 bps. The U.S. Stock Market Index underperformed by 1 bps, U.S. Stock Fund outperformed by 2 bps, the U.S. Large Stock Fund is even, and the U.S. Small Stock Fund outperformed by 15 bps for the quarter. The Overseas Fund underperformed by 435 bps for the quarter. The stock selection was the primary driver for underperformance, as well as underexposure to Asia and the tech area. The International Stock Fund outperformed by 17 bps.

Daily Priced Investment Options

The Savings Pool was at $576.2 million, down $18 million for the quarter due to money moving to other investment options and not due to investment return.

Labor and Industries' Funds

The Labor and Industries' Funds were at $9.3 billion, down $400 million for the quarter. The Accident Fund outperformed by 10 bps, the Medical Aid Fund underperformed by 2 bps, the Pension Reserve Fund outperformed by 71 bps, and the Supplemental Pension Fund ex-cash portion outperformed by 2 bp percent for the quarter.

Permanent and Other Trust Funds
Mr. Bruebaker reported that it was not a good quarter on performance, although the longer-term numbers still look good. The WSIB was hurt by holding CMOs instead of pass-throughs. The WSIB holds CMOs because clients want the stable income funds which are not managed on a total return basis. WSIB treasuries and credits did outperform, but it was not enough to offset the performance of the CMOs. The Other Trust Funds cash returns slightly underperformed at most by 2 bps, except for the Judicial Retirement and Reclamation funds, which outperformed for the quarter.

The Guaranteed Education Tuition Portfolio was at $405.2 million, up $32 million. All asset allocations are within their policy ranges. The performance for the quarter was down 10 bps although long-term performance remains solid.

The Developmental Disabilities Endowment Fund state portfolio was at $6.5 million and all asset classes are within their policy ranges. The private funds portfolio was at $803,000, up $85,000 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 March 31, 2004. Mr. Becker said that private equity is experiencing its fourth consecutive quarter of positive returns. One commitment authorized during the quarter was $25 million to Essex Woodlands Health Ventures VI and three commitments closed totaling $200 million: Essex Woodlands Health Ventures VI ($25 million), Endeavor IV ($50 million), and Silver Lake II ($125 million). Contributions totaled $268 million, which was 12 percent lower than the previous quarter. Distributions totaled $590 million, an increase of 31 percent from the fourth quarter. This high level of distributions represents 10 percent of the private equity portfolio and is the highest ever experienced by the WSIB. The combination of contributions and distributions during the quarter resulted in a positive cash flow for the quarter of $321 million, which is the second highest in WSIB history. Portfolio appreciation was at $106 million, compared to $500 million in the last quarter. The quarterly internal rate of return (IRR) was 1.8 percent, which held the inception to-date IRR at 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 $12.5 million, distributions were $204 million, and the portfolio appreciated by $6 million during the quarter. The unfunded commitments are at $1.5 billion. The LP portfolio IRR remained unchanged at 8.6 percent. Contributions were $256 million, distributions were $386 million, and the portfolio appreciated by $100 million. Unfunded commitments are at $3.5 billion.

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 portfolio posted a 0.4 percent return and the LP portfolio posted a 2.2 percent return for a combined return of 1.8 percent. For the ten-year period, the KKR portfolio posted a 14.9 percent return and the LP portfolio posted a 9.8 percent return. Combined returns are underperforming the benchmark for all periods except the five-year.

Looking at performance by sub-sector, distressed investments performed best with a 9.4 percent return, followed by mezzanine and other sub-sectors. The direct secondaries program is off to a strong start. The multiple on the invested capital was already at 1.7x. Large corporate finance and venture capital continue to outperform over the long-term. The KKR portfolio appreciated by $6.3 million and produced distributions of $204 million, and the LP portfolio appreciated by $100 million with 70 funds reporting gains. The portfolio's largest industry exposures were in manufacturing at 24 percent, technology at 12 percent, and health care at 11 percent.

Mr. Hanna asked what proportion of the $589 million in distributions was bought by another general partner in the WSIB portfolio. Mr. Becker said that PCG is currently working on that analysis and would provide the information within a few days.

Real Estate

Mr. Draper introduced Michael Humphrey from Courtland Partners who reported on the performance of the real estate portfolio through March 31, 2004. The total current market value of the portfolio is $4.19 billion. Mr. Humphrey reported that the net return is 2.5, 12.2, 10.8 and 11.5 percent for the quarter, one-, three-, and five-year periods respectively. He discussed the current market conditions. The top three investments comprise 40 percent of the portfolio: Hometown America, Principal Enterprise Capital (PEC), LoneStar III. LoneStar III combined with LoneStar IV represents 13 percent of the portfolio, which has produced a 20 percent plus return average. Mr. Humphrey reviewed the portfolio makeup of the WSIB investments. He reported that manufactured housing, residential, the west coast retail portion of the PEC portfolio, non-performing loan portfolios, and distressed real estate in Asia and Europe have worked well for the WSIB. He said that underperformance occurred with timber, office and R&D development properties in overbuilt markets, EuroInvest, and mid-west industrial.

In the benchmark comparison analysis, the WSIB has outperformed for the one-, three-, and five-year periods by 380, 410, and 310 bps respectively. WSIB's property type diversification compared to the NCREIF shows under allocation in retail, industrial, and office and over allocation in residential and the other category. The WSIB has 32 percent of its portfolio in the other category, which breaks down into 16-17 percent debt and other distressed debt investment vehicles, 8 percent timber, 3 percent land and hotel, and 4 percent cash from transactions involving Lowe Northwest and Hometown. Retail and industrial allocations are slightly under policy guidelines, but there are activities underway to remedy that. The portfolio's geographic diversification is under allocated to the East and Midwest, over allocated in the South, and matching in the West. There is no foreign exposure in the NCREIF; the WSIB has 27 percent of its portfolio in foreign, which is slightly over the policy guideline.

[Representative Sommers was in attendance at 10:22 A.M.]

Mr. Humphrey reviewed the leverage component of the portfolio, which is at 46 percent. He said the top five managers include Hometown at 17 percent, Hudson (Lone Star) at 14 percent, PEC at 14 percent, PAC Realty at 8 percent, and Morgan Stanley at 7 percent.

Mr. Nakahara asked about how U.S. fundamentals stood in comparison to Asia and Europe, and what the inflow and outflow of capital is from the U.S. to other global areas. Mr. Humphrey said that he has seen a strong demand for U.S. real estate coming from abroad, particularly from Western European institutional investors, which he feels is contributing to the inflow issue. Mr. Seely asked about the returns from Asia and the type of investments that Lone Star is doing with distressed properties where the underlying collateral values are higher, because the collateral is real estate. Mr. Humphrey responded that it is important to note that the strategy is still real estate-based.

Mr. Magnuson asked if there were plans to go long with fixed rates and increase leverage. Mr. Humphrey said that PEC is doing exactly that, although there is still a lot of conservatism with debt. In response to a question regarding damage from Hurricane Charley, Mr. Draper reported that the damage is less than expected. There were approximately 200 homes destroyed, particularly in one coastal community. Most of the damage was to landscaping, carports, etc. Mr. Draper reported that Hometown is working to repopulate the communities.

A discussion ensued relating to negative values reflected under Hearthstone and the poor performance of timber.

ADOPTION OF MINUTES – JUNE 17, 2004 AND JULY 22-23, 2004

Vice-Chair McElligott moved to adopt the Board minutes of June 17, 2004 and July 22-23, 2004. Ms. Brookman seconded and the motion passed unanimously.

[The Board recessed at 10:49 A.M. and reconvened in open session at 11:00 A.M.]

ELECTION OF CHAIR AND VICE-CHAIR

Mr. McElligott nominated Mr. Masten as Board Chair. There were no other nominations. Mr. Masten nominated Mr. McElligott as Vice-Chair. There were no other nominations.

Representative Sommers moved that the Board have a unanimous ballot to elect Mr. Masten as Board Chair and Mr. McElligott as Board Vice-Chair. Ms. Brookman seconded and the motion passed unanimously.

ADMINISTRATIVE COMMITTEE REPORT

Chair Masten reported that the Administrative Committee wished to proceed with the executive director's evaluation in January. He said that the Committee decided to develop a questionnaire for completion by all Board members and staff who report to the executive director. The anonymous questionnaires are to be returned to the Board Chair by December so that the evaluation can occur in January. Chair Masten reported that the Committee also discussed the executive director's salary. He reported that the 2004 evaluation of the executive director was completed in June, but that the salary action was postponed until September. Chair Masten noted that the R.V. Kuhns' study of investment officer salaries resulted in increases for the investment officers and chief investment officer in June. The Administrative Committee recommends that the executive director's salary increase by 6.5 percent, which reflects a 4 percent catch-up and a 2.5 percent cost of living adjustment.

Chair Masten moved that the Board approve the Administrative Committee's recommendation to increase the executive director's salary to $166,408 effective October 1, 2004. Ms. Brookman seconded the motion.

Mr. Brookman said that the Administrative Committee felt that the executive director's performance was good and that pay should match performance. She supports the recommendation.

The motion passed unanimously.

[Mr. Nakahara was not in attendance at 11:00 A.M.]

PRIVATE EQUITY PORTFOLIO REVIEW – KKR

Mr. Roberts and Mr. Michelson introduced themselves to the Board. Mr. Roberts provided an overview of KKR personnel, including its Europe team; the structures of the investment and portfolio management committees; and the firm's operational expertise, strategic advisors, and fund/ investor relations team. He described the Capstone Consulting team and its projects, which provides analysis of purchased companies, due diligence, and portfolio monitoring and improvement. Mr. Roberts described Fisher Capital, which is involved exclusively in KKR's activities in insurance and financial services. He gave examples of KKR's value creating approach.

Mr. Michelson discussed KKR's performance history, net cash flows, and recent distributions in the nine funds in which the WSIB has invested. He provided a status of the 1996 Fund and discussed new investments and remaining commitments.

[Senator Zarelli was in attendance at 11:32 A.M.]

Mr. Roberts provided an overview of the KKR Europe team, its personnel, industry focus, portfolio and experiences. He said that KKR would begin raising money soon for new European investments.

Mr. Hanna asked why the WSIB should commit to a new European fund when its commitment to Europe was 20 percent of the Millennium Fund, noting that the Board's guideline for international private equity investment is 20 percent of the private equity portfolio. Mr. Roberts replied that the decision to invest properly belongs to the Board. He noted that he is optimistic about the prospects for investing in Europe.

[The Board recessed at 11:55 A.M. and reconvened in open session at 12:30 P.M.]

AUDIT COMMITTEE REPORT

Internal Audit 2005-01, Real Estate

Chair Masten said that the internal audit of the real estate unit found that overall practices meet or exceed industry standards. There were a few recommendations, including: improve the documentation of investment philosophy and unit guidelines; obtain customer relationship management software to manage daily interactions with general partners; increase use of outside consultants for special projects to supplement staff's compliance, investment, and financial monitoring activities; and establish a database to improve management of and compliance with the terms and conditions of real estate contracts.

Chair Masten moved that the Board approve the Audit Committee's recommendation to accept the Internal Audit 2005-01, Real Estate recommendations. Vice-Chair McElligott seconded the motion.

Chair Masten advised Board members that the Private Markets Committee had discussed the resolution of audit recommendations related to the Principal Enterprise Capital investment. In response to a question from Mr. Magnuson, Ms. Vandehey explained that implementing the client management software recommendation would create a historical database of the day-to-day investment activity such as phone calls and daily interactions related to the investments that would be logged by the investment staff. Ms. Vandehey also clarified for Mr. Magnuson that Hometown security deposits are deposited centrally but were not being reconciled by the accounting office. Mr. Magnuson said he supports both recommendations.

The motion carried unanimously.

Conflict of Interest Policy 2.00.100 Revision

Chair Masten said that the proposed revision of the Conflict of Interest policy 2.00.100 included a number of housekeeping changes and more substantial clarifications on pages 17-20 relating to Board member and employee non-participation in certain activities when soliciting employment or being recruited for employment with a person or entity seeking to do business with the WSIB, required reporting when such a relationship exists, and post public service employment restrictions, which are more limiting than the state requirements.

Chair Masten moved that the Board approve the Audit Committee's recommendation to accept the Conflict of Interest policy 2.00.100 revision. Vice-Chair McElligott seconded the motion.

Mr. Hanna asked how the reasonable person provision could be enforced. Mr. Silver explained the responsibilities of both the former employee and entity seeking to do business with the WSIB; the perspective of the Board, staff and the Executive Ethics Board regarding the situation; the affect of reward of action or inaction; and time limitations.

The motion passed unanimously.

Nonvoting Board Members Term Expirations

Chair Masten reported that the terms of two nonvoting Board members, Mr. Nakahara and Mr. Seely, are expiring on December 31, 2004.

Chair Masten moved that the Board approve the Audit Committee's recommendation to reappoint Mr. Nakahara and Mr. Seely for three-year terms from January 1, 2005, through December 31, 2007. Vice-Chair McElligott seconded and the motion passed unanimously.

PRIVATE MARKETS COMMITTEE REPORT

Vice-Chair McElligott reported that the Private Markets Committee met on September 9 to discuss three investment recommendations, but was unable to take action on them due to a lack of quorum. He said that the consensus of the Committee members present at that meeting was to forward the recommendations to the Board for consideration.

Private Equity – Fortress Investment Fund III, L.P. – Investment Recommendation

Vice-Chair McElligott said that the Committee discussed an investment of up to $200 million in Fortress Investment Fund III, L.P. Fortress III is a $1.5 billion (target) private equity fund being formed primarily to make control-oriented investments in asset-backed businesses and asset portfolios in the United States and Western Europe. He reported that the WSIB has previously invested in two Fortress funds and one predecessor fund. Fortress has an experienced and stable management team. Fund III would continue the proven strategy of targeting cash-flowing investments backed by real estate and other tangible assets that can be acquired at a discount to intrinsic value. The group has a strong investment track record with substantial realizations. He reported that the economic terms of the partnership are favorable, particularly to large investors; and that the fund's differentiated, asset-based strategy would be an excellent fit in the private equity portfolio, representing an opportunity to expand a successful relationship to an existing partner.

Vice-Chair McElligott moved that the Board approve an investment of up to $200 million, plus fees and expenses, in Fortress Investment Fund III, L.P., subject to continued due diligence and final negotiations of terms and conditions. Mr. Gorton seconded and the motion passed unanimously.

Real Estate – Principal Enterprise Capital 1, LLC – Follow-on Investment

Vice-Chair McElligott reported that an additional investment of $600 million in Principal Enterprise Capital (PEC) 1, LLC, is recommended because the investment strategy is well suited to meet the WSIB's specific objectives for this element of its portfolio, including alignment of interests; capitalizing on an inefficiency in real estate capital markets at a time when capital-scarce opportunities are particularly rare; and complementing the opportunistic design of the combined real estate portfolio. He said that PEC 1 has performed competitively with other non-core investment options of similar risk profile and generally outperformed comparable entity investment opportunities. PEC 1 is structured effectively for risk management through a high degree of control. PEC maintains all the strengths for which it was originally selected, has significantly expanded its ability to execute the program, and draws on the broader resources of Principal Life Insurance (Principal). A timely commitment of this round of funding in an amount equal to or at least $400 million triggers the requirement that

Principal or its affiliates offer real estate entity investment services exclusively to the WSIB as long as it remains manager of PEC 1.

Vice-Chair McElligott moved that the Board approve an investment of up to $600 million, plus fees and expenses, in Principal Enterprise Capital 1, LLC, subject to continued due diligence and final negotiation of terms and conditions. Ms. Brookman seconded and the motion passed unanimously.

Real Estate – Lone Star V (U.S.), L.P. – Investment Recommendation
Vice-Chair McElligott said that a recommendation of up to $450 million in Lone Star Fund V (U.S.), L.P. is recommended. Lone Star V will be a fully discretionary, commingled, close-end fund that will invest in a broad range of real estate and financial opportunities, including secured and unsecured non-performing loans and financial-oriented operating companies with an emphasis on acquisition of assets backed by real estate collateral. Lone Star will primarily target investments in Asia and Germany. The Lone Star management team represents a dominant global franchise in the distressed debt industry with an experienced team, disciplined underwriting capabilities, and exceptional deal flow, much of it proprietary, and has demonstrated an ability to earn attractive risk-adjusted returns in distressed markets and identified geographic regions and national financial systems that are under severe economic pressure. He said that the WSIB has had a positive experience and relationship with Lone Star in four prior funds.

Vice-Chair McElligott moved that the Board approve an investment of up to $450 million, plus fees and expenses in Lone Star Fund V (U.S.), L.P., subject to continued due diligence and final negotiations of terms and conditions. Mr. Scott seconded and the motion passed unanimously.

[Senator Zarelli and Mr. Seely were no longer in attendance at 12:53 P.M.]

COST EFFECTIVENESS MEASUREMENT
Mr. Heale introduced himself to the Board. He reported on the results of the cost effectiveness analysis of the WSIB for the five-year period ended December 31, 2003. Mr. Heale described that the WSIB results were compared to Cost Effectiveness Measurement's (CEM) pension performance database of 134 U.S. funds. He said that the CEM report focuses on policy return, implementation value added, costs, and asset-liability mismatch risk. Mr. Heale said that the most meaningful comparison for WSIB returns and value added are to the U.S. universe, and that the most valuable comparison for cost is to a custom peer group of 20 funds because size impacts cost.

Mr. Heale reported that the WSIB's 5-year policy return of 4.1 percent was above both the U.S. and peer medians, which is reflective of the WSIB's under-weighting in domestic stocks and over-weighting in real estate and private equity. He said that under-weighting in fixed income created a negative impact. Mr. Heale said that the implementation value added measures the contribution from active management. He reported that the WSIB was slightly below both the U.S. and peer medians, but that the

WSIB had positive five-year in-category value added in each of its asset classes. Mr. Heale reported that the WSIB's five-year implementation risk of 2.6 percent is above the U.S. median. He said that asset mix impacts cost and implementation style is a big factor. He reported that the WSIB's lower use of external active management saved 8.7 bps relative to peers. He said that WSIB's oversight, custodial, investment management, and other costs were similar to peer funds. In summary, Mr. Heale reported that the WSIB was low cost primarily due to its low cost implementation style and that places the WSIB within the high value added/low cost quadrant of the CEM database.

In response to questions from the Board, Mr. Heale said that corporate pension plans are comparable in cost to public funds but they have more of a bias for active management. He said that brokerage transactions costs are not captured in the study. Mr. Bruebaker said that the Plexus report to be heard at the October Public Markets meeting would cover brokerage costs.

[Representative Sommers was no longer in attendance at 1:24 P.M.]

EXECUTIVE STAFF'S REPORT

Executive Director's Report

Mr. Dear provided the results of a staff satisfaction survey conducted in August, which showed improvement from a previous survey completed in 2003, and indicated a continuing need to improve communication, staff training and promotional opportunities. He also reported on recent inquiries as to whether the WSIB had any investments in companies illegally doing business with terrorist-supporting nations.

Monthly Investment Report

Mr. Bruebaker provided the CTF monthly investment report. For the month, U.S. equity returned 0.3 percent, outperforming the benchmark by 1 bp and added value of 20 bps for the year ended August 31. International equity returned 0.9 percent, outperforming the benchmark by 10 bps. Fixed income was up 1.8 percent, underperforming the Lehman Universal by 22 bps and underperforming the Lehman Aggregate by 15 bps for the month; the one-year performance has outperformed the Lehman Universal by 18 bps. The CTF was hurt by its shorter duration. CTF governments underperformed the index governments by 38 bps, due to its shorter duration and its TIPS exposure; CTF credits underperformed by 35 bps, due to duration; and securitized outperformed 12 bps due to CMOs. Private equity was even for the month. Draws were $176 million for the month. KKR draws were $127 million and $49 million of draws were from the rest of the portfolio. Year-to-date draws were at $1.2 billion, which was the second highest level of activity in the history of the WSIB only eight months into the year. Distributions were at $199 million. KKR distributions were $15 million and $184 million of distributions were from the rest of the portfolio. Year-to-date distributions were at $1.6 billion, which is a new record. No investments were approved or closed during August. Real estate returned .5 percent for month.

ASSISTANT ATTORNEY GENERAL'S REPORT

Chair Masten called the Board into executive session at 1:35 P.M. He said the purpose is to discuss litigation and potential litigation with legal counsel assigned to the Board since public knowledge regarding the discussion is likely to result in adverse legal or financial consequences to the WSIB. Chair Masten estimated that the executive session would last approximately five minutes, and after completion of the executive session, the Board would resume its open public session and that no further actions were anticipated.

[The executive session concluded at 1:46 p.m. and the open session reconvened immediately thereafter].

OTHER ITEMS
There was no further business to come before the Board. The meeting adjourned at 1:46 P.M.

George Masten
George Masten
Chair

ATTEST

Joseph A. Dear
Joseph A. Dear
Executive Director