WASHINGTON STATE INVESTMENT BOARD

Board Meeting Minutes
November 18, 2004

The Washington State Investment Board met in open public session at 9:30 A.M. in the boardroom at 2100 Evergreen Park Drive SW, Olympia, Washington.

Present:	George Masten, Chair Patrick McElligott, Vice-Chair Debbie Brookman John Charles Glenn Gorton Jeff Hanna Charlie Kaminski John Magnuson Treasurer Mike Murphy Bob Nakahara Jeff Seely Representative Helen Sommers Senator Joseph Zarelli
Absent:	Dave Scott Paul Trause
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 Diana Will, Senior Investment Officer – Asset Allocation Kristi Walters, Executive Assistant Paul Silver, Assistant Attorney General Eric Becker, Pacific Corporate Group

[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.

REAPPOINTMENT OATHS OF OFFICE – BOB NAKAHARA AND JEFF SEELY

Chair Masten administered reappointment oaths of office to nonvoting members Bob Nakahara and Jeff Seely for their three-year terms expiring December 31, 2007.

ADOPTION OF MINUTES – SEPTEMBER 16, 2004

Chair Masten noted a correction to show Paul Trause was absent.

> **Vice-Chair McElligott moved to adopt the Board minutes of September 16, 2004. Ms. Brookman seconded.**

Mr. Kaminski noted another correction to reflect that Senator Zarelli was present.

> **The above motion, as amended, carried unanimously.**

PUBLIC COMMENT

There was no public comment.

[Senator Zarelli was in attendance at 9:34 A.M.]

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 September 30, 2004.

Commingled Trust Fund

The CTF was at $43.4 billion, up $22.9 million for the quarter. U.S. equity was at $14.2 billion, with a negative return of 1.82 percent for the quarter. International equity was at $7.3 billion, with a return of 1.5 percent. Fixed income was at $11.2 billion, up $300 million.

Mr. Hanna asked why the real estate returns in staff's and Courtland's reports are different. Mr. Bruebaker said that real estate is time weighted in both cases. Ms. Will explained that the consultant gives staff the quarterly return for the CTF report. Occasionally, the consultant will restate those numbers and that does not flow back into the CTF report, which causes the differences. Ms. Will said that Courtland's numbers are the most accurate.

Defined Contribution Plans

For the quarter, the Teachers Retirement System Plan 3 was at $2.2 billion, up $35.9 million; School Employees Retirement System Plan 3 was at $637 million, up $10 million; and Public Employees Retirement System Plan 3 was at $830 million, up $9.9 million.

Treasurer Murphy asked how much of the quarterly change is attributable to earnings versus contributions. Mr. Bruebaker said that the WSIB does not track contributions. Mr. Charles said the Department of Retirement Systems (DRS) could assist. Treasurer Murphy said it would be helpful to see what the investment returns were versus the contributions added at least occasionally. Mr. Bruebaker said that he would get that detail for the current quarter and provide this information to Treasurer Murphy in the future for the Plans 3 and Deferred Compensation Plan (DCP).

The DCP was at $1.7 billion, up $41.9 million. Mr. Bruebaker said that the DCP is the 12th largest 457 plan in the United States, which speaks highly to the education DRS provides. The Judicial Retirement Account was at $13 million, up $100,000 for the quarter.

For the quarter, the Bond Market Fund underperformed by 68 basis points (bps). For the Cash Funds, the money market fund underperformed by 5 bps. The TAP Option outperformed by 104 bps. The Long Horizon underperformed by 11 bps, Mid Horizon underperformed by 30 bps, and Short Horizon underperformed by 32 bps. The Social Balanced Fund underperformed by 79 bps. The Equity Income Fund underperformed by 284 bps, the Independence Fund underperformed by 157 bps, and the Growth Company Fund underperformed by 111 bps. The U.S. Stock Market Index outperformed by 1 bps, U.S. Stock Fund underperformed by 1 bps, U.S. Large Stock Fund outperformed by 2 bps, and U.S. Small Stock Fund underperformed by 2 bps for the quarter.

Mr. Charles asked Mr. Bruebaker to discuss the performance of the Overseas Fund. Mr. Bruebaker said that the Public Markets Committee discussed this option at its last two meetings. Primarily for performance reasons, a recommendation to issue a Request for Proposals (RFP) to replace the Overseas Fund will be presented at the December Public Markets Committee meeting. The goal is to have a new investment option up and running before April 1, 2005, when Fidelity plans to implement a redemption fee, which would require participant notification.

The Overseas Fund underperformed by 130 bps for the quarter. The International Stock Fund outperformed by 7 bps.

Daily Priced Investment Options
The Savings Pool was at $598.9 million, up $22.7 million for the quarter.

Labor and Industries' Funds
The Labor and Industries' Funds were at $9.7 billion, up $400 million for the quarter. The Accident Fund was down by 24 bps, Supplemental Pension was down 1 bps, Pension Reserve Fund was up 18 bps, and Medical Aid Fund was down by 90 bps for the quarter.

Permanent and Other Trust Funds
Mr. Bruebaker reported that the Permanent Funds all underperformed by 3 to 26 bps. The Other Trust Funds cash returns underperformed 5 bps.

The Guaranteed Education Tuition Portfolio was at $416.2 million, up $11 million. All asset allocations were within their policy ranges. Performance for the quarter was even.

The Developmental Disabilities Endowment Fund state portfolio was at $6.6 million and all asset classes were within their policy ranges. The private funds portfolio was over $1 million, up $232,681 for the quarter. Performance was down 10 bps 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 June 30, 2004.

The private equity portfolio had a strong quarter. Commitments authorized were $235 million. Commitments closed were $205 million, including: Hellman & Friedman ($75 million), Oak XI ($100 million), and OCM V ($30 million). Commitments authorized in secondaries were: Francisco Partners, Spectrum IV, and Warburg Pincus International each at $10 million. Contributions totaled $632 million, which was up over 100 percent from the previous quarter. KKR accounted for about half of this activity. Clayton Dublier & Rice, Warburg Pincus, and Madison Dearborn accounted for about 40 percent of the remaining activity. Distributions totaled $726 million, an increase of 17 percent from the previous quarter. Portfolio appreciation was at $325 million, compared to $106 million in the last quarter. The quarterly internal rate of return (IRR) was 5.6 percent. This marks the fifth quarter of positive returns in the portfolio.

In response to a question from Vice Chair McElligott as to which partnerships accounted for the quarterly distributions, Mr. Becker said that the largest were from KKR and Joseph Littlejohn & Levy.

Mr. Becker reviewed venture capital and buyout fundraising, capital invested, primary and secondary equity offerings, and M&A activity.

The KKR portfolio IRR was unchanged at 16.5 percent. Contributions were $281 million, distributions were $253 million, and the portfolio appreciated by $47 million during the quarter. The unfunded commitments were at $1.3 billion. The LP portfolio IRR increased from 8.6 to 9.2 percent. Contributions were at $350 million, distributions were at $473 million, and the portfolio appreciated by $278 million. Unfunded commitments were at $3.3 billion.

For the quarter, the KKR portfolio posted a 3.8 percent return and the LP portfolio posted a 6.1 percent return. For the ten-year period, the KKR portfolio posted a 15.4 percent return and the LP portfolio posted a 10.7 percent return. Combined returns were outperforming S&P for all timeframes except inception.

Looking at performance by sub-sector, small/medium corporate finance performed best with a 17.9 percent return, followed by international at 8.4 percent.

Appreciation generated by KKR was $47 million, primarily in the 1987, 1996, & European funds. Eighty-two funds reported gains from the LP portfolio; 47 reported losses. LP portfolio appreciation came primarily from Fortress, Doughty-Hanson, BC Partners & First Reserve. Treasurer Murphy asked Mr. Becker to explain the distinction between the KKR and other LP portfolios with regard to the percentage of publicly-traded portfolios held. Mr. Becker said that KKR is defined by all investments made into KKR-managed vehicles. All the companies that are defined as public are divided by the total value of the portfolio to determine percentages. Forty percent of the companies actively managed by KKR are public. In the LP portfolio, the percentage

is 27.5 percent. The KKR portfolio is more mature and is likely to have more public companies. In response to a question from Treasurer Murphy, Mr. Becker said that the portfolio does contain IPOs that have not been liquated.

Mr. Becker said that the venture capital allocation stood at 15 percent, which is at the lower end of the range. Unfunded stands at 19 percent. Sizeable commitments will need to be made to that sub-sector. PCG plans to discuss with staff the appropriate strategy for venture capital.

Mr. Kaminski asked what the international exposure would be on a look-through of corporate finance. Mr. Becker said it was 31 percent of the portfolio. Mr. Bruebaker said that staff would examine that at the annual planning session to be held later in the month.

A discussion ensued about the effect on investments when commitments are done in Euros versus U.S. dollars. Mr. Ruggels said there is no choice involved and that the investment is done in whatever currency the fund is denominated. Mr. Becker said that PCG evaluates the issue often and adjusts as needed. Mr. Bruebaker said that staff also plans to discuss the issue at the annual planning session.

Mr. Kaminski asked that PCG add two paragraphs to page 2 of their quarterly report providing international and distressed market overview information.

Real Estate

Mr. Draper reported on the performance of the real estate portfolio through June 30, 2004. The portfolio had approximately $4.1 billion of equity invested, which represents 9.4 percent of CTF assets. $3.2 billion is in unfunded commitments, approximately 55 percent of which are commitments to the real estate operating companies (REOC) strategy, 15 percent is to actively investing funds, and 14 percent is related to investments in some stage of liquidation and unlikely to be drawn. The remaining commitments are in other strategies. Staff is gradually repositioning the portfolio to reduce exposure to underperforming managers and low-growth or weaker markets, and is effectively increasing the overall quality of the portfolio. Mr. Draper highlighted the WSIB's returns for the one-, three-, and five-year periods, and compared them to the NCREIF index. Treasurer Murphy asked if the NCREIF index included leverage; Mr. Draper said that NCREIF is not leveraged. The WSIB does not replicate the benchmark, it compares against it with a goal to exceed it. Mr. Draper reported that the income returns over the one-, three-, and five-years were 6.7, 6.8, and 7.2 percent respectively. The WSIB is not heavily dependant on appreciation for returns, but strong short-term appreciation may occur in the next two quarters. The future expectation for real estate is that it is entering a period of probable modest returns. The gross-to-net return spread of the portfolio has been widening, primarily as a result of some partners beginning to earn carried interest.

Treasurer Murphy asked Mr. Draper to identify the property types labeled as "other." Mr. Draper said that, in rough terms: 8 percent is natural resources; 2 percent is land; 1 percent is receivables and cash; 8 percent is classified as debt instruments (primarily non-performing loans); and a variety of Lone Star investments, including a large bank and other ventures, financial companies, and a chain of restaurants accounted for most of the rest. Mr. Draper said that this information is currently

reported as a footnote but that he would have Courtland add a graphic display of the components of "other" in future reports. Mr. Draper reviewed the geographic diversification and portfolio leverage.

Senator Zarelli suggested that staff should continue to consider properties to develop and turn for a substantial rate of return in the short term. Mr. Draper said that Lone Star and Hearthstone are good examples of existing partners that do this, but that risk in the portfolio should be balanced with reward. He said that most of staff's efforts are geared toward creating a growing portfolio of income producing property and that most properties developed by WSIB's partners are held to produce income.

[The Board recessed at 11:00 A.M. and reconvened in open session at 11:15 A.M.]

AUDIT COMMITTEE REPORT

Conflict of Interest Compliance Review

Mr. Charles reported that the Audit Committee met on November 2. Mr. Silver provided the annual conflict of interest compliance review. His review concluded that Board members and staff of the Board continue to demonstrate a commendable awareness and understanding of and compliance with the requirements of the Board's Conflict of Interest policy and of the State Ethics in Public Service law.

> **Mr. Charles moved that the Board accept the Audit Committee's recommendation to accept the Conflict of Interest Compliance Review. Treasurer Murphy seconded.**

Senator Zarelli asked if legislative members are required to report gifts over $50 twice, both to the WSIB and as required for elected officials. Chair Masten directed that staff streamline the process so that elected officials do not have to report twice. Mr. Dear said that staff would look at more efficient reporting.

> **The above motion carried unanimously.**

Internal Audit 2005-02, Bloomberg Portfolio Order Management System

Mr. Charles said that the Audit Committee received an internal audit report on the Bloomberg Portfolio Order Management System (POMS), which is the newly implemented fixed income trading system. Mr. Charles reported that POMS provides straight-through processing and post trade compliance monitoring. Internal audit had four recommendations: (1) refine access privileges; (2) include POMS in business continuance planning; (3) obtain legal advice before fully automating the system to address retention of paper tickets; and (4) perform reconciliations consistently and timely. Mr. Charles stated that staff reported a successful testing of business continuance operations on November 5, and have assigned more staff to perform reconciliations consistently and on time.

Mr. Charles moved that the Board accept the Audit Committee's recommendation to accept the Internal Audit Report 2005-02, Bloomberg Portfolio Order Management System recommendations. Ms. Brookman seconded and the motion carried unanimously.

2005 Proxy Voting Plan

Mr. Charles reported that staff contracted Glass Lewis & Co., LLC/Investor Responsibility Research for proxy research and voting for 2005. Staff is working with Glass Lewis to develop a draft proxy voting policy for the Audit Committee's review at its December 6 special meeting. Mr. Charles said that the policy is expected to come before the full Board at its December 16 meeting.

PUBLIC MARKETS COMMITTEE REPORT

Mr. Gorton reported that the Public Markets Committee met on October 5 to receive a report from Plexus on trade execution, review transitions accomplished in 2004, and receive an analysis on the transition of the international equity portfolio assets from State Street Global Advisors, Frank Russell Securities, Goldman Sachs, and Plexus. He said that Barclays Global Investors provided a review of the domestic equity portfolio and discussed introduction of a portfolio alpha product. Mr. Gorton said that the Committee met again on November 2 to receive portfolio reviews from three of the four international emerging markets managers: F&C, GMO, and Schroder.

Mr. Bruebaker reported on the restructure of the international equity program, which was 50 percent active and 50 percent passive, and is now 60 percent active, 20 percent passive, and 20 percent enhanced. Staff is requesting to move from a fixed emerging markets allocation of 5 percent, to a range of 5 to 10 percent. Mr. Bruebaker said that, each June, staff would establish a rate, starting with 6 percent in 2004. This strategy allows managers to opportunistically choose to be either under or overweight emerging markets.

Mr. Gorton moved that the Board accept the Public Markets Committee's recommendation to establish an emerging markets allocation range of 5 to 10 percent, allow staff to annually reset a target within that range, and rebalance assets accordingly based on a cost/benefit analysis that considers transaction costs. And, that the Board accept the Public Markets Committee's recommendation to terminate Schroder Investment Management North America for performance and organizational concerns. Vice Chair McElligott seconded and the motion carried unanimously.

Mr. Gorton reported that the Committee approved its 2005 meeting schedule, discussed activities to replace the Fidelity Overseas option in the Deferred Compensation Program and Judicial Retirement Account, and reviewed the Watchlist.

PRIVATE MARKETS COMMITTEE REPORT

Ms. Brookman reported that the Private Markets Committee met on November 4 to discuss two investment recommendations. She said that a quorum was not present, so the recommendations

have been forwarded to the Board for consideration based on the consensus of those members present at the meeting.

Private Equity – CHS Private Equity V, L.P. – Investment Recommendation
Ms. Brookman reported that Code Hennessy & Simmons (CHS) is forming a $1.25 billion private equity fund that will invest in middle-market companies. CHS V will follow the same strategy as previous CHS funds, investing primarily in manufacturing, distribution, and service companies with valuations under $500 million. The WSIB previously invested in three CHS funds, with commitments of $12.3 million to CHS II, $30 million to CHS III, and $125 million to CHS IV. CHS has an experienced, cohesive investment team with minimal turnover of investment professionals in its 15-year history. The CHS investment team has originated and led investments in 55 platform companies and completed 125 add-on acquisitions. The fund will continue the proven and focused strategy of making control investments in the middle-market manufacturing, distribution, and service sectors. The CHS team has produced a solid overall track record since 1991, with an aggregate net IRR of 15.4 percent including realizations of $876 million on investments of $1.3 billion. The middle-market "old-economy" focus of the fund is an excellent fit in the private equity portfolio and provides an opportunity to extend a successful relationship with a quality existing partner.

> **Ms. Brookman moved that the Board approve an investment of up to $125 million, plus fees and expenses, in CHS Private Equity V, L.P., subject to continued due diligence and final negotiation of terms and conditions with special attention to the key person provision. Mr. Charles seconded.**

Treasurer Murphy expressed concern with the performance of CHS III, stating that a fund of its vintage ought to be doing much better. Treasurer Murphy also expressed concern with the fee offset, noting that the staff should attempt to negotiate more favorable terms. A discussion ensued about the key man provision, CHS III performance, and the fee offset.

> **The above motion carried with Treasurer Murphy voting no.**

Real Estate – Evergreen Real Estate Partners, LLC – Follow-on Investment
Ms. Brookman reported that Evergreen Real Estate Partners, LLC represents the next major step in implementing the WSIB's primary real estate strategy of investing in REOCs. The partnership will invest in and with REOCs nationally, targeting a return premium of 200 to 300 bps above the NCREIF index. Evergreen's primary focus will be on owning controlling interests in REOCs. The partnership will provide small-to-medium-sized REOCs with an alternative capitalization strategy not typically available within the marketplace.

Evergreen is sponsored by Macquarie Capital Partners (MCP) a leading player in the capitalization of REOCs in the U.S. and Europe. Evergreen will provide considerable diversification for the WSIB real estate portfolio. Each REOC investment owns many properties and is diversified by geography and property type. MCP has considerable experience working with REOCs in non-traditional property types such as self-storage, senior housing, and parking, which are currently absent from the WSIB real estate portfolio. MCP has established itself as a

leader in providing capital to REOCs. Mr. House specifically has been involved with marrying billions of dollars of capital to REOCs over the past 12 years and is well known and respected in the industry. Evergreen additionally benefits from access to the skills, experience, and contacts of approximately 26 other MCP professionals and the resources of Macquarie Bank's U.S. real estate group.

Evergreen's governance provisions are consistent with the WSIB's preferred real estate portfolio structure. The managing member can be removed by the WSIB at any time with or without cause. Staff will have the ability to veto major capital decisions and approve an annual budget. Evergreen will have exclusive access to this strategy from MCP as long as the partnership has capital available to invest.

The partnership's financial terms and conditions are very attractive compared to many alternatives in the marketplace. The carried interest terms for Evergreen are better than market and do not include a catch-up mechanism. The asset management fee of 0.25 percent is below market and, combined with direct costs of the partnership, the total cost (other than carried interest) of investing in Evergreen will initially be approximately 55 to 60 bps on committed capital. MCP's affiliation with Macquarie Bank may provide valuable contacts and opportunities for the WSIB outside of Evergreen on a global basis. Also, while Evergreen will be empowered to operate in the U.S. only, MCP has operations in Europe that could provide a future expansion of the partnership's strategy. Investment performance of deals led by the MCP team has been very good (projected net IRR of 17.1 percent versus an original aggregate target IRR of 14.6 percent); however, since most of the investments were intended to be long term in nature, few full realizations are present in the track record. Most of the transactions sponsored by MCP have outperformed original expectations to date. Staff has a long-standing relationship and familiarity with Mr. House and the MCP team.

> **Ms. Brookman moved that the Board approve an investment of up to $500 million, plus fees and expenses, in Evergreen Real Estate Partners, LLC, subject to continued due diligence and final negotiation of terms and conditions. Mr. Charles seconded.**

Treasurer Murphy stated a concern that MCP had no track record. Mr. Draper pointed out that Evergreen has had a tremendous amount of success identifying the best investment teams and marrying capital to them, and the relationship of that track record is extremely important.

[Mr. Kaminski was no longer in attendance at 11:54 A.M.]

Mr. Magnuson summarized said that: (1) The investment is efficient. It is important that the WSIB decentralize the management oversight and investment responsibility. The REOC strategy is almost, by necessity, the WSIB's preferred strategy and gives the best returns. (2) Real estate is still a very local business, especially in the non-core, non-traditional type of investments. (3) WSIB control of the investment is attractive and is set-up in this investment. The WSIB controls the deal and has all the power in the transactions. WSIB staff has demonstrated the ability to exercise that control. (4) The co-investment and alignment of interest

of the principals is very important, and the amount equates to a significant portion of the net worth of the principals. The principals are motivated to make excellent returns. (5) This allows the WSIB the flexibility to invest in non-core, non-traditional property types. Although riskier than traditional investments, the return is higher. (6) This investment reduces the WSIB reliance on PEC, Hometown, Washington Holdings, and PacTrust, which is a good, defensive posture to take. Evergreen will invest in different types of properties and markets, so it is a complimentary rather than competitive arena. Mr. Magnuson concluded that Evergreen is an excellent fit in the WSIB real estate investment strategy, and he recommends the investment.

The above motion carried with Treasurer Murphy voting no.

EXECUTIVE STAFF'S REPORT

Executive Director's Report

Mr. Dear provided his monthly report for November. Staff conducted a disaster recovery drill successfully on November 5. A more complete test is scheduled for April 2005. In response to questions from Mr. Nakahara, Mr. Dear said that it took less than one hour for staff to move to the off-site Tumwater location and get systems up and running. Additional transit time would need to be considered if relocation to Wenatchee or Vancouver became necessary. There are costs for the equipment kept off-site and modest charges for use of the facilities. Staff will check on the need for locations outside of Washington State.

Monthly Investment Report

Mr. Bruebaker provided the CTF monthly investment report. For the month, U.S. equity returned 1.6 percent, underperforming the benchmark by 1 bp. International equity returned 3.5 percent, outperforming the benchmark by 2 bps. Fixed income was returned 0.9 percent, which matched the Lehman Universal and was 7 bps over the Lehman Aggregate for the month. Private equity returned 0.5 percent. Draws were $257 million for the month. KKR draws were $70 million and $187 million of draws went to the rest of the portfolio. Distributions were at $246 million. KKR distributions were $124 million and $122 million came from the rest of the portfolio. Year-to-date distributions were at $2.1 billion, which represents a record for WSIB at only ten months into the year. No investments were approved in October. Fortress III closed in October; $200 million was approved for investment, but $175 million was the amount of the fund the WSIB was able to get. Real estate returned 0.1 percent, as did cash.

ASSISTANT ATTORNEY GENERAL'S REPORT

There was nothing to report.

OTHER ITEMS

Chair Masten reported that the Board would evaluate the executive director in January. A form was developed which will be mailed out to each Board member and to those staff reporting directly to the executive director. Chair Masten said that he hoped to mail it the week of November 22, with a request to return completed forms by December 10. The Administrative Committee will act on the evaluation and report to the Board in January.

There was no further business to come before the Board. The meeting adjourned at 12:18 P.M.

George Masten
Chair

ATTEST

Joseph A. Dear
Executive Director