# WASHINGTON STATE INVESTMENT BOARD

## Board Meeting Minutes
## December 16, 2004

The Washington State Investment Board met in open public session at 9:32 A.M. in the boardroom at 2100 Evergreen Park Drive SW, Olympia, Washington.

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| Present: | George Masten, Chair (teleconferenced)<br>Patrick McElligott, Vice-Chair<br>Debbie Brookman (teleconferenced)<br>John Charles<br>Glenn Gorton<br>Jeff Hanna (teleconferenced)<br>Charlie Kaminski<br>John Magnuson<br>Mike Murphy<br>Bob Nakahara<br>Jeff Seely<br>Representative Helen Sommers<br>Dave Scott<br>Paul Trause<br>Senator Joseph Zarelli |
| Also Present: | Joe Dear, Executive Director<br>Gary Bruebaker, Chief Investment Officer<br>David Thatcher, Contracts Manager<br>Kristi Walters, Executive Assistant<br>Paul Silver, Assistant Attorney General<br><br>Scott Daniels, Conning Asset Management<br>Jay Kloepfer, Callan Associates |

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

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

**ADOPTION OF MINUTES – NOVEMBER 18, 2004**

**Mr. Charles moved to adopt the November 18, 2004, Board meeting minutes. Mr. Gorton seconded and the motion passed unanimously.**

**PUBLIC COMMENT**

There was no public comment.

[Representative Sommers was in attendance at 9:34 A.M.]
[Senator Zarelli was in attendance at 9:35 A.M.]

## LABOR & INDUSTRIES' FUNDS ANNUAL PRESENTATION

Mr. Bruebaker introduced Scott Daniels of Conning Asset Management. Mr. Daniels gave the annual presentation on the Labor & Industries (L&I) funds. He discussed L&I's long-term portfolio investment strategy, how changes in L&I's financials led to a review of the investment strategy, and the unique needs of a workers' compensation insurer.

Mr. Daniels reviewed the strategic portfolio objectives. Treasurer Murphy asked Mr. Daniels to explain his statement that Comparable Market Indices (CMIs) are flawed. Mr. Daniels explained that there is no cash in the CMIs and L&I does hold some cash, which causes differences in returns that L&I actually earns in portfolios and the CMIs. Mr. Daniels said this is probably as little as 5 basis points (bps) difference. He said a larger difference is mortgage-backed securities (MBS). The funds hold substantial investments in MBS since they tend to provide a high level of investment income. MBS hold a lot of structured securities and there are no market indices for these, only pass through indices. Mr. Daniels said the MBS strategically provide a lesser return than CMIs but provide more income. He said that the portfolio has about 20 percent in MBS.

Mr. Daniels continued his report, commenting on L&I investment returns. He said that the Medical Aid Fund has somewhat under performed the CMI over time. In response to Treasurer Murphy's question as to what that is attributed to, Mr. Daniels said that, in part, cash and MBS, the decision to extend duration from 4 to 6 in the spring and how that is being done through cash flows versus selling bonds. He said that interest rates have been flat to down during that period. The CMI was lengthened immediately. Also, WSIB staff made a tactical decision to reduce the amount of risk in the portfolio by reducing credit exposures. Low credit bonds performed badly during some of the corporate scandals over the past few years.
[Mr. Seely was in attendance at 9:54 A.M.]

The report included comparisons between other state retirement fund and private insurer peer groups with regard to profitability measures, leverage, asset allocation, stock allocation trends, surplus exposures, bond sector allocation, and bond portfolio maturity and quality.

In response to a question from Senator Zarelli, Mr. Daniels said that L&I premiums are lower relative to benefits paid, and that premiums would generally be higher for those insurance companies making a profit. In response to a question from Treasurer Murphy, Mr. Daniels explained that BBB rated bonds are in the portfolio for additional investment income. Mr. Daniels said the current strategy is appropriate.

## AUDIT COMMITTEE REPORT

### Proxy Voting Policy 2.05.200 Revision

Mr. Charles reported that the Audit Committee met on December 6 to hear a presentation by Kevin Cameron of Glass Lewis on proxy voting and consider changes to the proxy voting policy. Mr. Charles said that 85 percent of all proxy voting occurs between March and the first week in May due to the scheduling of annual meetings and the Securities and Exchange Commission (SEC) timelines. He said that it is ineffective from a cost standpoint to staff up to deal with all of the issues. Glass Lewis is staffed and organized to handle the seasonal workload. The Board retains the flexibility to pull out certain proxy voting issues to discuss and make decisions on.

**Mr. Charles moved that the Board accept the Audit Committee's recommendation to adopt the revised Proxy Voting policy 2.05.200. Treasurer Murphy seconded the motion.**

Treasurer Murphy reminded the Board that he commented on the issue last spring where Barclays Global Investors was asked by the Board to vote a certain way on an issue and they declined. He said that he is very comfortable with the policy and complimented the Audit Chair on the fine work done so far. Treasurer Murphy pointed out that this is the first step in the corporate governance issue. He reported that he had been asked to serve on a corporate governance committee of the National Association of State Treasurers. He is hopeful to form partnerships and share information with other states. Treasurer Murphy said that he supports the motion.

**The above motion passed unanimously.**

## PUBLIC MARKETS COMMITTEE REPORT – DCP AND JRA INTERNATIONAL EQUITY OPTION RFP CONCEPT DOCUMENT

Mr. Gorton reported that the Public Markets Committee met on December 7. The Committee reviewed a proposed concept document that would allow the WSIB to search for a new international equity option in the Deferred Compensation Program and Judicial Retirement Account.

**Mr. Gorton moved that the Board approve the Public Markets Committee's recommendation to authorize staff to issue a Request for Proposal for an international equity option for the Deferred Compensation Program and Judicial Retirement Account, and that the Request for Proposal reflect the scope of services and terms consistent with the Concept Document contained in our binders. Mr. Charles seconded the motion.**

Treasurer Murphy pointed out that the motion does not specifically state that Fidelity would be dropped as a manager. Mr. Bruebaker said that assets would be transferred from Fidelity once a new manager is selected.

**The above motion passed unanimously.**

Mr. Gorton reported that the Committee also heard portfolio reviews from two of the WSIB's defined contribution plan managers, Walden Asset Management and Fidelity Investments, and one of the WSIB's emerging markets equity managers, Capital International, Inc.

[The Board recessed at 10:20 A.M. and reconvened in open public session at 10:40 A.M.]
[Ms. Brookman, Mr. Hanna, and Chair Masten were in attendance at 10:40 A.M.]

## PRIVATE MARKETS COMMITTEE REPORT

Mr. Charles reported that the Private Markets Committee met on December 2 to consider three investment options and review a concept document.

**Private Equity – KKR European Fund II, L.P. Investment Recommendation**
Mr. Charles reported that the Private Markets Committee recommends an investment of up to $500 million in KKR European Fund II, LP, a $3 billion European buyout fund. Fund II will target large buyout transactions outside of the U.S. and Canada, primarily in Western Europe.

KKR is the WSIB's largest private equity relationship. Since 1983, the WSIB has committed more that $4.2 billion to KKR investments. The investment recommendation of the Private Markets Committee is based, in part, on the following: KKR has a strong franchise, reputation, and network of industry relationships in North America that have extended to Europe; the KKR management team is very experienced, deep, and stable; and the firm has developed a talented, multi-national European team based in London, which was visited by staff this year; the firm's overall long-term investment record has been excellent through multiple investment cycles with substantial cash realizations. As of June 30, 2004, KKR has returned $5.9 billion on WSIB's $4.0 billion investment in addition to the remaining value of $1.4 billion. Although more recent, KKR's European track record is also strong; the KKR strategy is focused on value creation post-investment by leveraging the extensive resources of the firm, including internal industry teams, strategic advisors, and a captive consulting group (Capstone), with the oversight of the firm's Portfolio Management Committee; and this is an opportunity to expand a successful, long-term relationship with a high-quality partner.

> **Mr. Charles moved that the Board accept the Private Market Committee's recommendation to approve an investment of up to $500 million, plus fees and expenses, in KKR European Fund II, L.P., subject to continued due diligence and final negotiation of terms and conditions. Mr. Trause seconded the motion.**

Treasurer Murphy referenced a letter sent to Mr. Scott from Mr. George Roberts of KKR, which relates to an issue in 2003 where KKR attempted to modify the Board's structure legislatively with regard to nonvoting Board members. Also distributed was an article from Bloomberg on the issue. Mr. Scott asked KKR to respond to the Bloomberg article relative to the point that the article left the impression that KKR was acting in isolation. Treasurer Murphy stated that he shared that view. The KKR letter stated that they had discussed the issue with others, including Treasurer Murphy. Treasurer Murphy stated that no drafts were shared with him by KKR. He said that he received amendatory drafts only through legislative staff. Treasurer Murphy said that he felt this was an improper activity from a general partner.

Treasurer Murphy said that staff had recommended a smaller investment at the Private Markets Committee and so had Pacific Corporate Group. He was not aware of the additional due diligence performed to move the recommendation to a higher figure. Treasurer Murphy said that he is unable to support the recommendation until KKR changes the way they deal with the Board.

Mr. Gorton said that he felt he could support the recommendation based on discussion at the Private Markets Committee, but only at $400 million.

Mr. Charles remarked that it is the responsibility of trustees to act on behalf of the members with regard to decision-making, and it was with that in mind that consideration of the $500 million was requested. He said that he had learned about the availability of additional money just prior to the meeting from Mr. Dear. Mr. Charles said that the WSIB should take advantage of the opportunity to move into Europe when it's most advantageous and he supports the full amount.

Treasurer Murphy requested to hear the staff analysis of this investment. Mr. Bruebaker commented that staff was divided on the amount to invest; not whether or not KKR would make money for the WSIB. It came down to portfolio concentration with one manager, and a desire to make other partners more of an equal size. He said that 22.5 percent of the portfolio is with KKR currently, and that would increase to 28.5 percent in the year 2008 if the Board approves the $500 million investment. Mr. Bruebaker said that $500 million is reasonable and prudent, but it is the Board's decision to make.

Mr. Trause asked what the difference in concentration would be at the $260, $400, and $500 million levels. Mr. Bruebaker said that he did not have the percentage for a $260 million investment, but that $400 million would take the percentage to 26.9 by 2008 compared to the previously cited 28.5 percent with a $500 million commitment.

A discussion ensued with regard to the contribution rate assumption used to calculate the increased capacity for commitments to international private equity.. Staff described the methodology used, which involves a number of assumptions developed by staff, PCG and the State Actuary. A mid-range contribution rate was used to reach the percentage estimates. Mr. Magnuson referenced Attachment 1 in the Board packet from PCG on assumptions. Mr. Bruebaker clarified that the 2004 numbers listed on the attachment include the balance as of June 30, 2004 and the activity amounts for the remaining 6 months of the year.

Mr. Kaminski commended staff and the Board on the good work. He said that the Board has benefited since the inception of the relationship in immeasurable ways. With respect to the motion, Mr. Kaminski said he was comfortable with $400 million with successful resolution of one of the two terms yet to settle in negotiations. One term is with regard to preferred return for the limited partners. The other relates to the transaction fee split. Mr. Bruebaker said that he did not believe the WSIB would be successful with regard to the preferred return negotiation. He said that he did believe that the transaction fee negotiation would be successful.

Mr. Seely said that based on comments at the last meeting, he started to be supportive of the $400 million level. When the motion was for $500 million, it was based on new information on fund contributions and CTF estimates. He had requested more data and supporting material. Mr. Seely referenced the Board presentation Mr. Roberts gave a few months back where he said that there would be three or four dominant brands at the top of the market, small brands at the bottom, and the rest stuck in the middle. Mr. Roberts said that the dominant funds are where public funds need to be. Mr. Seely pointed out that the Board competes against CalPERS, Michigan, etc., for investment opportunities and it should look at the numbers carefully to ensure it does not under-invest. The Board needs to focus on returns. Mr. Seely reminded members that the Board has asked to get larger positions with other high quality general partners in past deals without success because of the competition from other investors. Mr. Seely said a

significant portion of funds over the next five years need to go into international investments. He said he is comfortable with the recommendation at $500 million.

Mr. Hanna pointed out the exposure to European deals, as Mr. Ruggels had stated at the Committee meeting. At $400 or $500 million, the Board would have six times as much concentration with KKR as with any other general partner. Mr. Ruggels knows of specific funds coming. He had identified a billion dollars he wanted to invest between now and 2007 without including KKR Europe. The Board needs to invest $300 million a year in international to maintain exposure. Mr. Hanna said he could not see anything in the new cash flow figures that would require the Board to invest $500 million. He said he thought $200 million was fine. Mr. Hanna commented on the level of the Euro now versus recent time periods. Mr. Hanna said that at $500 million, the Board would be very near the top of its range. Doing so at this time is buying very expensive Euros and he said he did not think it was a good thing to buy high.

Chair Masten said that, with regard to legislative action, he has always opposed any change to the Board's statute. He further stated that he has not let that influence his investment decisions. In 2003, Chair Masten made a motion to oppose the legislation related to nonvoting members and directed the executive director to oppose it. The bill did not pass. Chair Masten said he is concerned that the Board hears about opportunities, but the proposals do not come forward for a maximum amount. The Board sees a lot of small opportunities versus big investments. Chair Masten said that KKR is a good investment and he strongly supports $500 million.

Mr. Nakahara said that staff and members serving on the Committee have done a good job deliberating. He fully supports the recommendation. With regard to the concentration, past the 20 percent level, the difference between 26 and 28 percent is not material. KKR has had a good track record since inception and has consistently performed in top tier quartiles. He said that Europe is a very rich environment and KKR has identified companies that are inefficient and they can reap significant gains in their restructuring.

Representative Sommers raised two points. The Governor is proposing to reduce the contributions from the state into the pension system by stretching out the structure of the contributions. That saves money in this very tough time but it does mean there will be fewer resources. Whatever the assumption was about the funds available for investment needs to be kept in mind. She said her other point was with regard to the Euros. Representative Sommers asked about the discussion or assumption at the Committee meeting with regard to making an investment from $400 to $500 million at the current Euro level.

Mr. Bruebaker said that there have been a number of in-depth conversations over the past year about currency overlay opportunities and the related pros and cons. He said that in some years the Board has benefited from the Euro and in some years not. The Board has always considered currency hedging to be at best a zero sum proposition. The staff planning to review currency overlay at the portfolio level during the upcoming asset liability study.

Mr. Scott said he had asked a direct question to Mr. Roberts and was assured there were no future plans to try to influence the Board's structure and he was satisfied with the response.

Mr. Scott said he is in agreement with Mr. Gorton in that he is not comfortable with investing $500 million.

Ms. Brookman said she is in favor of supporting the motion for $500 million. She sees a lot of value with KKR and wants to see it continue.

**The above motion passed with Treasurer Murphy, Mr. Gorton, and Mr. Scott voting no.**

**Private Equity – BC European Capital VIII, L.P. Investment Recommendation**
Mr. Charles reported that the Private Markets Committee voted to recommend an investment of up to €160 million in BC European Capital VIII, L.P., a €4.5 billion private equity fund that will focus on large buyout transactions in Europe. The WSIB has previously invested in two BC Partners funds, with commitments of $35 million to Fund VI in 1997, and $96 million to Fund VII in 2000.

The Committee indicated an interest in considering a larger commitment to the fund, if available, and directed staff to inquire as to the availability of a larger commitment, should the WSIB choose to pursue a larger amount. Following the meeting, staff contacted BC Partners, and the firm indicated they would make "best efforts" to secure up to an additional €65 commitment for the WSIB (for a total of €225 million, or approximately U.S. $300 million using exchange rates as of December 3, 2004), but cannot guarantee the availability of that amount. Staff believes that this is an excellent opportunity to expand a successful relationship with a top tier existing partner, and is revising its original recommendation, requesting that the Board approve a commitment of up to €225 million, plus fees and expenses, in BC European Capital VII, L.P. Pacific Corporate Group also supports a commitment of up to €225 million.

The investment recommendation of the Private Markets Committee is based, in part, on the following: BC Partners has a deep and experienced multi-national team of 37 investment professionals operating out of offices in London, Paris, Milan, Geneva, and Hamburg; the firm has a superior reputation and an extensive network of industry relationships throughout Europe, which contributes to quality deal flow and proprietary opportunities; BC Partners has an excellent track record with a 28.9 percent net IRR on €4.7 billion invested in seven prior funds with a low loss ratio. Forty-three of the firm's 56 investments to date have been fully realized, generating €6 billion in proceeds; and BC will continue its successful investment approach, focusing on large, control investments in the U.K. and Western Europe.

**Mr. Charles moved that the Board approve an investment of up to €225 million, plus fees and expenses, in BC European Capital VIII, L.P., subject to continued due diligence and final negotiation of terms and conditions. Treasurer Murphy seconded and the motion passed unanimously.**

**Real Estate – Morgan Stanley Real Estate Fund V International – T.E., L.P. Investment Recommendation**

The Private Markets Committee recommends an investment of up to $440 million (including a 10 percent reserve), plus fees and expenses, in Morgan Stanley Real Estate Fund V International – T.E., L.P. (MSREF V). The WSIB has previously committed to MSREF III International and MSREF IV International, the first two real estate funds sponsored by Morgan Stanley that had a purely non-U.S. investment mandate.

The investment recommendation of the Private Markets Committee is based, in part, on the following: the MSREF V management team represents a very strong global franchise in the real estate industry. This team is deep and experienced, and unusually, has modest reliance upon any key persons; this is a true global (ex-U.S.) fund and as such provides substantial diversification benefits to the WSIB. As a global organization, Morgan Stanley, and in turn MSREF V, can benefit from moving to whatever markets worldwide that provide the most attractive investment opportunities. Their emersion into the local and regional markets gives them access to exceptional deal flow, much of it proprietary; the MSREF management team has demonstrated, over a series of funds, their ability to identify and manage attractive real estate transactions. They differentiate themselves from other real estate groups with which the WSIB invests by targeting larger transactions, often with a corporate angle. Terms of MSREF V are improved over the previous two funds since WSIB staff has been successful in negotiating new terms for "super major" investors of $400 million or more. The new terms have replaced fixed fees that would have been paid to Morgan Stanley with additional incentive-based carried interest. Staff has had a very positive experience and relationship interacting with MSREF V's management team through the WSIB's investment in two prior funds since 1998. Unlike many other groups that raise closed-ended, discretionary real estate funds, this team has communicated openly and frequently about details of their activities. They listen to suggestions from investors and regularly implement them. Staff has also benefited from access to extensive market knowledge and research from this group and the larger Morgan Stanley organization.

> **Mr. Charles moved that the Board approve an investment of up to $440 million (including a 10 percent reserve), plus fees and expenses, in Morgan Stanley Real Estate Fund V International – T.E., L.P., subject to continued due diligence and final negotiation of terms and conditions. Treasurer Murphy seconded the motion.**

Mr. Magnuson said he was in favor of motion from a real estate standpoint. He said that Morgan Stanley does an exceptional job in Europe. Mr. Magnuson said that the performance of MSREF III was not stellar, but he feels they were positioning themselves for great success.

Mr. Nakahara asked about the risk factors with regard to governance. He stated that the risk for this fund appeared to be more similar to the governance provisions found in the private equity funds rather than the normal governance provisions the WSIB has in other real estate opportunities. Mr. Nakahara asked staff to amplify on this and describe what mitigating factors make staff believe this would not be a factor.

Mr. Bruebaker stated that this fund structure is more of a traditional fund investment for real estate. This is the only way we can get the investment in this fund. We are an important investor to this general partner and they listen to any concerns we have and we have a good working relationship with them.

**The above motion passed unanimously.**

[Ms. Brookman, Mr. Hanna, and Chair Masten were no longer in attendance at 11:45 A.M.]

**Real Estate Consultant RFP Concept Document**
Courtland Partners was hired by the Board in May 2000 to provide general real estate consulting services to the Board. The current contract term expires June 30, 2005. The RFP process needs to be started at this time in order to be completed prior to the expiration of the current contract. This RFP Concept Document reflects an anticipated continuation of the current scope of services in the area of general consulting and also provides for audit-related services.

**Mr. Charles moved that the Board authorize the issuance of a Request for Proposal for general real estate consulting services and real estate partnership auditing services, and that the Request for Proposal reflect scope of services and terms consistent with the Concept Document. Treasurer Murphy seconded the motion.**

Treasurer Murphy questioned the length of the contract and asked staff if a shorter term with potential extensions wasn't the standard. Mr. Bruebaker said that the Board retains the right to terminate five-year contracts. Mr. Thatcher said that a minimum of five day's notice is required. Mr. Bruebaker said that more notice would need to be given from an operations consideration, but we have the option.

Mr. Magnuson said he supported the motion. He complimented the real estate staff for being six months ahead with this work.

**The above motion passed unanimously.**

Vice Chair McElligott thanked staff for their efforts.

[Senator Zarelli was no longer in attendance at 11:52 A.M.]

## STAFF'S REPORT

**Executive Director's Report**
Mr. Dear provided his report of Board, staff, investments, operational, and communications activities during the month of December.

**Monthly Investment Report**
Mr. Bruebaker provided the CTF monthly investment report for November. For the month, U.S. equity returned 4.6 percent, underperforming the benchmark by 3 basis points for the month and underperforming of 2 bps for the year ended November 30, 2004. International equity returned

6.7 percent, underperforming the benchmark by 50 bps for the year ended November 30, 2004. Fixed income had a negative return of 50 bps for the month, but outperformed the Lehman Universal by 9 bps and outperformed the Lehman Aggregate by 27 bps. The one-year performance has outperformed the Lehman Universal by 14 bps. Private equity was up 0.1 percent for the month. Draws were at $82 million for the month. KKR draws were $4 million; $78 million of draws were from the rest of the portfolio. Distributions were at $143 million. KKR distributions were $29 million and $114 million of distributions were from the rest of the portfolio. Year-to-date distributions were at $2.2 billion for 11 months of this year, which is a record. One investment was approved and closed during the month, Code Hennessey V. Real estate returned 0.3 percent and cash returned 0.2 for the month.

**ASSISTANT ATTORNEY GENERAL'S REPORT**

Mr. Silver said that there was nothing to report.

[The Board recessed 11:54 A.M. and reconvened in open public session at 12:15 P.M.]
[Mr. Nakahara was no longer in attendance at 12:15 P.M.]

**EDUCATION SESSION – ASSET ALLOCATION**

Mr. Bruebaker introduced Jay Kloepfer of Callan Associates. Mr. Kloepfer provided an educational session on asset allocation, focusing on asset classes and strategy to consider in the 2005 WSIB capital market assumptions.

[Representative Sommers was no longer in attendance at 12:45 P.M.]
[Treasurer Murphy was no longer in attendance at 12:58 P.M.]

[Mr. Magnuson was no longer in attendance at 1:22 P.M.]

**OTHER ITEMS**

There was no further business to come before the Board. The meeting adjourned at 1:26 P.M.

Pat McElligott
Vice Chair

ATTEST

Joseph A. Dear
Executive Director