WASHINGTON STATE INVESTMENT BOARD

Board Meeting Minutes
February 17, 2005

The Washington State Investment Board met in open public session at 9:31 A.M. in the boardroom at 2100 Evergreen Park Drive SW, Olympia, Washington.

Present:	George Masten, Chair Debbie Brookman Senator Lisa Brown John Charles Glenn Gorton Charlie Kaminski John Magnuson Treasurer Mike Murphy Bob Nakahara Dave Scott Paul Trause
Absent:	Patrick McElligott, Vice-Chair Jeff Hanna Jeff Seely Representative Helen Sommers
Also Present:	Joe Dear, Executive Director Gary Bruebaker, Chief Investment Officer Tom Ruggels, Senior Investment Officer-Private Equity Steve Draper, Senior Investment Officer-Real Estate Kristi Walters, Executive Assistant Paul Silver, Assistant Attorney General Eric Becker, Pacific Corporate Group Michael Humphrey, Courtland Partners

[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 – JANUARY 20, 2005

Mr. Masten noted corrections in the last paragraph on page 6, changing "Committee" to "Board" in the first and third sentences.

> **Treasurer Murphy moved to adopt the January 20, 2005, Board minutes as corrected. Ms. Brookman seconded and the motion carried unanimously.**

PUBLIC COMMENT

There was no public comment.

[Senator Brown was in attendance at 9:35 A.M.]

OATH OF OFFICE FOR NEW MEMBER

Chair Masten administered the oath of office to Senator Lisa Brown, who will serve a two-year term from February 1, 2005, to December 31, 2006. Senator Brown said she looks forward to working with the Board.

> **Chair Masten moved to appoint Senator Brown to the Private Markets Committee in accordance with the Board Charter policy 1.00.110. Treasurer Murphy seconded and the motion carried unanimously.**

[Senator Brown was no longer in attendance at 9:40 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 December 31, 2004.

Commingled Trust Fund

The CTF was at $46.1 billion, up $2.78 billion for the quarter. U.S. equity was at $15.6 billion, up $1.4 billion for the quarter. International equity was at $8.3 billion, up $1 billion for the quarter. Fixed income was at $11.4 billion, up $200 million for the quarter. Although the CTF underperformed the TUCS Public Fund >$1B Median by 80 bp for the quarter, it has outperformed by 147 bps, 33 bps, 4 bps, and 26 bps for the one-, three-, five-, and ten-year periods respectively.

Defined Contribution Plans

For the quarter, the Teachers Retirement System Plan 3 was at $2.4 billion, up $214 million. Net contributions were $36.9 million and net earnings were $177.1 million. The School Employees Retirement System Plan 3 was at $685 million, up $48 million. Net contributions were $5.1 million and net earnings were $43.1 million. The Public Employees Retirement System Plan 3 was at $897 million, up $66.5 million. Net contributions were $8.6 million and net earnings were $58 million.

The DCP was at $1.8 billion, up $143 million for the quarter. Net contributions were $19.6 million and net earnings were $123.6 million. The Judicial Retirement Account was at $13.9 million, up $899,000 for the quarter. Net distributions were $10,000 and net earnings were $909,000.

For the quarter, the Bond Market Fund underperformed by 2 basis points (bps). For the Cash Funds, the money market fund underperformed by 7 bps. The TAP Option also underperformed

for the quarter. The Long Horizon underperformed by 7 bps, Mid Horizon underperformed by 5 bps, and Short Horizon underperformed by 6 bps. Each of the Horizon fund components underperformed: U.S. equity by 5 bps, International equity by 13 bps, the Bond fund by 2 bps, and cash by 9 bps. The Social Balanced Fund outperformed by 110 bps. The Equity Income Fund underperformed by 144 bps, the Independence Fund underperformed by 108 bps, and the Growth Company Fund outperformed by 389 bps. The U.S. Stock Market Index underperformed by 5 bps, U.S. Stock Fund outperformed by 1 bp, U.S. Large Stock Fund outperformed by 1 bp, and U.S. Small Stock Fund underperformed by 6 bps for the quarter. The Overseas Fund underperformed by 109 bps for the quarter. The International Stock Fund under performed by 13 bps.

Labor and Industries' Funds
The Labor and Industries' Funds were at $10 billion, up $300 million for the quarter. The Accident Fund, Pension Reserve Fund, and the Supplemental Pension outperformed the CMI. The Medical Aid Fund underperformed due to duration.

Permanent and Other Trust Funds
Mr. Bruebaker reported that the Permanent Funds underperformed, except for the Common School Fund. Performance was hurt by shorter duration. The Other Trust Funds underperformed, except for the Reclamation Revolving Fund.

The Guaranteed Education Tuition portfolio was at $458 million, up 10 bps for the quarter. All asset classes are within their ranges. The Developmental Disabilities Endowment Fund state portfolio was at $6.8 million and the Private Funds were at $1.5 million. Performance is good in this portfolio for both the state and private funds.

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 September 30, 2004.

The private equity portfolio had another strong quarter, with a 4.6 percent quarterly return. Mr. Becker said this represents the sixth consecutive quarter of positive returns. The portfolio's inception to date IRR as of September 30, 2004, was 13.6 percent, up from 13.1 percent as of September 30, 2003.

Contributions during the quarter were $526 million, a decrease of 17 percent from the previous quarter. Distributions totaled $589 million, a decrease of 19 percent from the previous quarter. The distribution activity for the quarter was the third highest level in the history of the portfolio. The portfolio appreciated by $283 million, compared to $325 million in the last quarter.

Mr. Becker reviewed venture capital and buyout activity, capital invested, primary and secondary equity offerings, portfolio liquidity, and M&A activity. He reported that the number of partnerships has increased to 138 with the closure of Fortress Investment Fund III. There were no investments exited during the quarter.

The KKR portfolio appreciated by $189 million. This resulted in an increase in their since-inception IRR to 16.6 percent from 16.5 percent at the end of the prior quarter. KKR contributions were $211 million; distributions were $242 million. The LP portfolio appreciated by $94 million during the quarter, and the since-inception IRR decreased slightly from 9.2 to 9.1 percent. Contributions were $315 million; distributions were $347 million.

For the quarter, the KKR portfolio posted a 13.5 percent return and the LP portfolio posted a 2.0 percent return. Mr. Becker reported that performance for all periods was positive and the combined portfolio returns in all periods outperformed the S&P 500. The portfolio has outperformed the S&P 500 + 500 bps benchmark in four of the seven periods.

Looking at performance by sub-sector, international performed best with a 12.5 percent return for the quarter, followed by distressed and small/medium corporate finance with 6.1 and 4.6 percent returns respectively. All sub-sector allocations are within their target ranges. The portfolio is well diversified with the largest exposure in manufacturing at 26 percent and technology and biotech/healthcare each at 12 percent.

Real Estate

Mr. Draper introduced Michael Humphrey from Courtland Partners who reported on the performance of the real estate portfolio through September 30, 2004.

Mr. Humphrey said that the real estate portfolio has continued to perform well. The total current market value of the portfolio is $4.138 billion. This represents 9.6 percent of total plan assets. Mr. Humphrey reported that net returns are 3.1, 11.6, 11.2 and 11.4 percent for the quarter, one-, three- and five-year periods respectively.

Mr. Humphrey reported on the five largest investments that comprise 50 percent of the real estate portfolio: Hometown America, Principal Enterprise Capital, Lone Star IV, Hawthorne Timber, and Lone Star III. The Board discussed the primary usage of Hawthorne Timber's products, the long-term value of the investment, the difference between Hawthorne Timber and ForesTree investments, and the impact Canadian imports have had on timber.

Treasurer Murphy asked for an explanation of Hearthstone's returns. Mr. Humphrey said that Hearthstone overdistributed funds to the WSIB that they will recall later to payback project loans, fees, etc. He said that the negative equity balance skews return calculations so they are noted as "not meaningful" in Courtland's report. The historical IRR on Hearthstone Olympia is just over 13 percent.

Mr. Humphrey said that, in the benchmark comparison analysis, the WSIB has outperformed for the one-, three- and five-year periods. Mr. Humphrey briefly discussed property type and geographic diversification, manager concentration, investments by manager, and market conditions. He said that declining cap rates indicate that values are increasing.

In response to Mr. Magnuson's question about the difference in transaction-based and appraisal-based cap rates, Mr. Humphrey said that appraisers are backward-looking and base appraisals on values closed in the market. He said that transaction-based and appraisal-based cap rates smooth out over time.

Mr. Humphrey said that the WSIB has done well with taking advantage of the lesser relative risk in some of the core plus, value and opportunistic arenas. The marketplace is just starting to recognize that. Treasurer Murphy commented that he'd heard appreciation in real estate is insane. He asked if unrealized appreciation would ever be realized and what affect higher interest rates might have. Mr. Draper said that many economists tend to focus on single-family dwellings when discussing real estate and not the types of investments that the WSIB has. He said that the WSIB is conservative with its policies on valuing its properties. In response to points raised by Mr. Trause, Mr. Humphrey said that historical trends and liquidity should be considered when looking for future investment markets. Mr. Draper said that the WSIB sometimes takes more risk on the front end of a project and then turn them into core products.

[The Board recessed at 11:00 A.M. and reconvened at 11:10 A.M.]

PUBLIC MARKETS COMMITTEE REPORT

DCP/JRA International Equity Option Finalist Selection

Mr. Gorton reported that the Public Markets Committee met on February 1. The first issue before the Committee was the selection of an international equity option for the Deferred Compensation Program and Judicial Retirement Account. The Committee listened to a presentation by State Street Global Advisors, the apparently successful offeror recommended by staff. The Committee concurred with staff's recommendation.

> **Mr. Gorton moved that the Board accept the Public Markets Committee's recommendation to select State Street Global Advisors as the apparently successful offeror for the defined contribution plan core international equity mandate, subject to continued due diligence and successful negotiation of terms and conditions. Mr. Charles seconded.**

Mr. Charles complimented staff on the procurement and noted that this is an exceptional opportunity.

> **The above motion carried unanimously.**

Contract Extensions

Mr. Gorton reported that the following WSIB contracts will expire in 2005 and are eligible for extensions: Barclays Global Investors (BGI) for domestic equity index investment management; Conning Asset Management for Labor and Industries' industrial insurance consulting services; Frank Russell Securities, Inc. for directed brokerage and soft dollar services; and State Street Bank for securities lending services. He said that all firms are performing well and meeting contract expectations.

Mr. Gorton moved that the Board accept the Public Markets Committee's recommendation to authorize the executive director to extend the contract with: Barclays Global Investors, Contract Number 02-005, for one year, through December 31, 2006, as provided in the terms of the contract; Conning Asset Management, Contract Number 02-006, for one year, through December 31, 2006, as provided in the terms of the contract; Frank Russell Securities, Inc., Contract Number 01-016, for one year through December 31, 2006, as provided in the terms of the contract; and State Street Bank, Contract Number 02-004, for two years through September 30, 2007, as provided in the terms of the contract. Mr. Trause seconded.

Treasurer Murphy said that he disagreed with BGI's conclusion on page 3 under Proxy Voting. A discussion followed concerning BGI's position on a vote last year and the WSIB proxy voting guidelines.

Treasurer Murphy asked if the State Street Bank contract extension is a subset of the custodial contract. Mr. Bruebaker responded that the securities lending contract is separate, but staff would only execute the securities lending contract extension if the Treasurer approves the custodial contract extension at the end of this year.

Treasurer Murphy moved to separate the issues and consider the State Street Bank contract extension as a separate motion. Mr. Gorton seconded and the motion carried unanimously.

The motion to approve the contract extensions with: Barclays Global Investors, Conning Asset Management, and Frank Russell Securities, Inc., carried unanimously.

The motion to authorize the executive director to extend the contract with State Street Bank, Contract Number 02-004, for two years through September 30, 2007, as provided in the terms of the contract carried with Treasurer Murphy abstaining.

Mr. Gorton reported that the Committee also listened to annual reviews of products managed internally by the WSIB.

PRIVATE MARKETS COMMITTEE REPORT

Private Equity

Bridgepoint Europe III

Ms. Brookman reported that the Private Markets Committee recommends an investment of up to €100 million (approximately U.S. $130 million using exchange rates as of January 19, 2005) in Bridgepoint Europe III, a €2.0 billion (target) pan-European buyout fund. If approved, Bridgepoint will be a new general partner relationship for the WSIB. The investment recommendation is based, in part, on the following: 1) The firm has a deep and experienced multi-national investment team with 46 investment professionals operating from seven offices in

six European countries. 2) The firm has a solid investment record with an 11.8 percent net IRR on €3.7 billion invested since 1991, including realizations of €3.6 billion from over 200 investments. 3) Bridgepoint will continue its successful, disciplined investment approach focusing on middle market, control investments in European companies with enterprise values of €50 million to €500 million. The firm targets well-run companies with a strong potential to grow organically, through acquisition, or via pan-European expansion. 4) If approved, Bridgepoint Europe III would add complementary portfolio exposure to European middle market companies.

Ms. Brookman moved that the Board accept the Private Markets Committee's recommendation to approve an investment of up to €100 million, plus fees and expenses, in Bridgepoint Europe III, subject to continued due diligence and final negotiation of terms and conditions. Mr. Charles seconded and the motion carried unanimously.

Menlo Ventures X, L.P.

Ms. Brookman reported that the Private Markets Committee recommends an investment of up to $250 million in Menlo Ventures X, L.P., a multi-stage venture capital fund with a target capitalization of $1.0 billion. Menlo Ventures is the WSIB's longest standing private equity relationship. Since 1981, the Board has committed $403.6 million to eight Menlo Ventures funds. The investment recommendation is based, in part, on the following: 1) Menlo Ventures is a well-established, highly regarded "brand name" venture capital firm with an excellent reputation and an extensive network of industry relationships, providing the firm access to a significant volume of high quality investment opportunities. 2) The investment team is very experienced, with extensive domain expertise in the firm's target investment sectors. The stability of the team over many years is a competitive advantage. 3) The firm has generated an impressive investment record over a long time-period with significant realizations. Since 1981, Menlo has invested $1.56 billion and generated nearly $3.2 billion in realizations. The WSIB's aggregate net IRR on all Menlo Ventures investments since 1981 is 21.8 percent. 4) The team will continue its proven, proactive and systematic investment strategy focused on identification of emerging technology markets and companies that provide "real products for real customers with real problems." 5) The fund provides quality venture capital exposure, a sub-sector that is at the low end of its target range in the WSIB private equity portfolio. 6) This is an opportunity to expand a successful, long-term relationship with a high-quality investment partner.

Ms. Brookman moved that the Board accept the Private Markets Committee's recommendation to approve an investment of up to $250 million, plus fees and expenses, in Menlo Ventures X, L.P., subject to continued due diligence and final negotiation of terms and conditions. Mr. Charles seconded.

Treasurer Murphy said that while Menlo Ventures experienced remarkable performance through fund VII, the performance of funds XIII and IX has been poor. Treasurer Murphy said that he does not support the recommendation.

The above motion carried with Treasurer Murphy voting no.

Palamon European Equity II, L.P.
Ms. Brookman reported that the Private Markets Committee recommends an investment of up to €100 million (approximately U.S. $130 million using exchange rates of January 19, 2005), plus fees and expenses, in Palamon European Equity II, L.P., a pan-European middle-market private equity fund with a target capitalization of €650 million. Palamon is an existing general partner relationship as the Board committed €50 million to Palamon European Equity in May 1999. The investment recommendation is based, in part, on the following: 1) Palamon has an experienced multi-national investment team with diverse backgrounds in private equity investing, investment banking, banking/finance, strategic consulting, and operational management. 2) Fund II will continue the firm's proven thesis-driven, sector-focused strategy to acquire or create companies in the small to middle pan-European market. 3) Fund I, with a weighted average life of only two years, has distributed nearly 70 percent of its invested capital as of December 31, 2004, and has the potential for significant additional upside. 4) Palamon has an alignment of interest with both limited partners and portfolio companies. All transaction, break-up, and other fees offset the management fee. Additionally, Palamon does not take fees out of portfolio companies for advice and continuing assistance. 5) The Fund's pan-European small and middle market focus is an excellent fit in the portfolio. 6) Fund II is an opportunity to expand our relationship with an existing quality partner.

> **Ms. Brookman moved that the Board accept the Private Markets Committee's recommendation to approve an investment of up to €100 million, plus fees and expenses, in Palamon European Equity II, L.P., subject to continued due diligence and final negotiation of terms and conditions. Mr. Charles seconded.**

Treasurer Murphy noted that the investment terms are okay, but the management fee is a bit high. He said that Fund I had one transaction carrying the weight of its performance. Treasurer Murphy said that he is uncomfortable with the investment.

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

<u>Real Estate</u>
Cherokee Investment Partners IV, L.P.
Ms. Brookman reported that the Private Markets Committee recommends a $350 million investment in Cherokee Investment Partners IV, L.P. (Fund IV). Fund IV is the continuation of Cherokee's strategy investing in environmentally-tainted property (brownfields) in North America and Western Europe. Fund IV will invest in transactions requiring $25 million or more of total capital (including reserves). Cherokee is an existing partner relationship since 1998. The proposed investment is consistent with the real estate annual plan discussed with the Committee in January 2005. The investment recommendation of the Private Markets Committee is based, in part, on the following: 1) Investing in brownfields is an attractive strategy that can generate superior risk adjusted returns. Of the 42 transactions completed by Cherokee since 1993, 20 have been fully realized generating an IRR of 106 percent and a return on equity of 2.5x cost. The aggregate net projected return for all 42 transactions is 55 percent with a return

on equity of 2.1x cost. Targeted net returns for Fund IV are 20 percent. 2) Cherokee is the leader and the dominant franchise in brownfield investing. The management team has proven to be adept at managing the unique execution challenges that come with investing in brownfields. They have extensive risk management and environmental expertise, disciplined underwriting capabilities, and exceptional deal flow. Cherokee has established an outstanding reputation in a sector that has limited competition from traditional capital sources. The momentum they have gained and their specialized capabilities serve as barriers to entry for others, resulting in a significant competitive advantage relative to others attempting to invest in this area. 3) Fund IV will represent the largest pool of commingled discretionary capital available for the exclusive use of acquiring environmentally tainted real estate. Cherokee and staff believe that this should create a competitive advantage, especially for large transactions involving multiple properties in differing locations. The complexity and perceived risks associated with the ownership of environmentally impaired real estate assets also limits the number of competitors. There continues to be an abundant supply of real estate assets with environmental-related problems. Changing market fundamentals, such as urbanization and heightened social and environmental awareness, as well as the increased availability of public financing and economic incentives for brownfield investments, also create an improving environment for investing in brownfields. 4) Staff has had a very positive experience and relationship interacting with Cherokee'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. Other WSIB real estate partners have also benefited from working with Cherokee.

> **Ms. Brookman moved that the Board accept the Private Markets Committee's recommendation to approve an investment of up to $350 million, plus fees and expenses, in Cherokee Investment Partners, L.P., subject to continued due diligence and final negotiation of terms and conditions. Treasurer Murphy seconded.**

Mr. Scott said he had heard anecdotally of community concerns in developing properties in Colorado and California. He asked staff to comment. Ms. Brookman said that the issue was also discussed at the Committee meeting. Mr. Draper clarified that Cherokee cleans up environmental pollution so properties can be put into productive use. Cherokee does not build buildings on the property. He said that the community concerns surround what the property will ultimately be used for. Mr. Bruebaker said that a key point in Cherokee's strategy is alignment of interest with the communities in which they invest. This is fundamental and integral to how Cherokee invests. Mr. Trause stated concerns about remediation costs and the investment's dependency on the two key principals. He asked what assurances the WSIB has regarding the two individuals remaining actively involved. Mr. Draper responded that Cherokee purchases insurance products that cap the cost of remediation, and that the agreement contains key man provisions that allow the WSIB to cease investment in the fund if either individual is not there. Mr. Magnuson commented that Cherokee is the team to invest with in this particular strategy.

The above motion carried unanimously.

CCP, L.P.

Ms. Brookman reported that the Private Markets Committee recommends an investment of $200 million in CCP, L.P. CCP will be enabled to invest in environmentally tainted property investments (brownfields) globally, with a strong emphasis on major markets in the U.S. Investments will encapsulate all transactions originated by Cherokee that meet their underwriting criteria, but do not meet the investment parameters of Cherokee Fund IV. This will include transactions requiring less than $25 million of total capital (including reserves). CCP will also be empowered to co-invest in transactions with Fund IV. The proposed investment is consistent with the real estate annual plan discussed with the Committee in January 2005. The investment recommendation is based, in part, on the following: 1) The same positive attributes noted for Fund IV regarding the Cherokee organization and brownfield investing are also applicable to an investment in CCP. 2) Additionally, the governance provisions of CCP are consistent with the preferred structure for the WSIB's real estate portfolio. The managing member can be removed by the WSIB at any time with or without cause. Staff will also have the ability to approve an annual business plan and to veto major capital decisions. CCP will also have exclusive access to this strategy from Cherokee as long as the partnership has capital available to invest.

Ms. Brookman moved that the Board accept the Private Markets Committee's recommendation to approve an investment of up to $200 million, plus fees and expenses, in CCP, L.P., subject to continued due diligence and final negotiation of terms and conditions. Treasurer Murphy seconded and the motion carried unanimously.

Mr. Nakahara suggested that staff look at investments in other developing countries, such as Russia, Korea, India and China. Mr. Dear said that the private equity annual plan includes a potential allocation to a general partner investment in Asia to be identified later this year. Mr. Bruebaker said that staff is constantly looking around the globe.

STAFF'S REPORT

Executive Director's Report

Mr. Dear provided his monthly report for February on board governance, staff, investments, operations, communications and legislation activities. He briefed the Board on California Governor Arnold Schwarzenegger's proposal to close all state and local defined benefit plans in California and replace them with defined contribution plans beginning in 2007. Treasurer Murphy's press release on the proposal was distributed to the Board.

Treasurer Murphy elaborated on the proposal and his opposition to it. He suggested that the Board entertain a position that the proposal is not in the best interest of the country. Mr. Charles agreed with Treasurer Murphy. He commented on how the proposal came about in California and suggested that there is potential for that to also occur in Washington. Mr. Charles said that continuing with defined benefit programs is in the best interest of members. Mr. Dear said he will participate in a meeting on the subject at the Council of Institutional Investors meeting in April.

Monthly Investment Report
Mr. Bruebaker provided the CTF monthly investment report for January 2005. For the month, U.S. equity lost 2.6 percent, outperforming the benchmark by 2 bps and matching its performance for the year. International equity lost 1.8 percent, underperforming the benchmark by 5 bps for the month and by 35 bps for the year. International equity has outperformed the benchmark by 50 bps since the Board restructured it effective July 1, 2004. Fixed income was up 0.4 percent, underperforming the Lehman Universal by 23 bps. TIPS hurt performance in January. For the year, fixed income outperformed the Lehman Universal by 4 bps and the Lehman Aggregate by 54 bps. Private equity was up 2 percent for the month. Draws were $97 million: $18 million from KKR and $79 million from the rest of the portfolio. Activity is down from last year's average monthly draws of $158 million. Distributions were at $221 million: $60 million from KKR and $161 million from the LP portfolio. Last year's average was $215 million. The portfolio had 7 or more IPOs during the first two weeks in February. No investments were approved or closed during the month. Real estate returned 0.3 percent for month.

ASSISTANT ATTORNEY GENERAL'S REPORT
Chair Masten called the Board into executive session at 12:08 P.M. He said the purpose is to discuss litigation or potential litigation matters. Chair Masten estimated that the executive session would last five minutes, and after completion of the executive session, the Board would resume its open public session.

[Mr. Trause was no longer in attendance at 12:21 P.M.]
[Mr. Magnuson was no longer in attendance at 12:25 P.M.]

[The executive session concluded at 12:34 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 12:35 P.M.

George Masten
Chair

ATTEST

Joseph A. Dear
Executive Director