**WASHINGTON STATE INVESTMENT BOARD**
**Board Meeting Minutes**
**May 19, 2005**

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

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| Present: | Treasurer Mike Murphy, Acting Chair<br>Debbie Brookman<br>Senator Lisa Brown<br>Glenn Gorton<br>Jeff Hanna<br>Charlie Kaminski<br>John Magnuson<br>Sandra J. Matheson<br>Bob Nakahara (via teleconference)<br>Dave Scott<br>Representative Helen Sommers<br>Gary Weeks |
| Absent: | George Masten, Chair<br>Patrick McElligott, Vice-Chair<br>Jeff Seely |
| Also Present: | Joe Dear, Executive Director<br>Gary Bruebaker, Chief Investment Officer<br>Tom Ruggels, Senior Investment Officer-Private Equity<br>Steve Draper, Senior Investment Officer-Real Estate<br>Diana Will, Senior Investment Officer-Asset Allocation<br>Kristi Walters, Executive Assistant<br>Paul Silver, Assistant Attorney General<br><br>Tara Blackburn, Pacific Corporate Group<br>Mike Krems, Pacific Corporate Group<br>Bob McCrory, EFI Actuaries<br>Allan Emkin, Pension Consulting Alliance |

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

Treasurer Murphy called the meeting to order and roll call was taken.

**OATH OF OFFICE FOR NEW MEMBER**

Treasurer Murphy administered the oath of office to Gary Weeks, the newly appointed Labor and Industries Director.

## COMMITTEE ASSIGNMENT

**Treasurer Murphy moved to appoint Mr. Weeks to the Public Markets Committee in accordance with the Board Charter Policy 1.00.110. Mr. Scott seconded and the motion carried unanimously.**

## ADOPTION OF MINUTES – APRIL 21, 2005

**Mr. Scott moved to adopt the April 21, 2005, Board minutes. Mr. Gorton seconded and the motion carried unanimously.**

## PUBLIC COMMENT

There was no public comment.

## QUARTERLY PERFORMANCE REPORTS

Mr. Bruebaker provided the quarterly reports for the commingled trust fund (CTF), defined contribution plans, daily priced investment options, Labor and Industries' funds, and permanent and other trust funds for the period ended March 31, 2005.

### Commingled Trust Fund

The CTF was at $46.5 billion, up $363 million for the quarter. U.S. equity was at $15.3 billion, down $300 million but outperforming the benchmark by 6 basis points (bps) for the quarter. International equity was at $7.7 billion, down $600 million. Mr. Bruebaker reviewed the performance of the international developed markets and emerging markets managers. Fixed income was at $12 billion and outperformed for the quarter by 11 bps due to governments and credits, and continues to outperform the benchmark for all periods.

### Defined Contribution Plans

For the quarter, the Teachers Retirement System Plan 3 was at $2.5 billion. The quarterly change reflected net contributions of $35 million and investment returns of negative $5 million for a net change of $30.6 million. The School Employees Retirement System Plan 3 was at $694 million and reflected net contributions of $5 million and investment returns of $3.7 million for a net change of $8.7 million for the quarter. The Public Employees Retirement System Plan 3 was at $905 million and reflected net contributions of $8 million and investment returns of $547,000 for a net change of $8.5 million for the quarter.

The Deferred Compensation Program was at $1.8 billion and reflected net contributions of $13 million and investment returns of negative $26 million for a net change of negative $13 million for the quarter. The Judicial Retirement Account was at $13.9 million and is in a net payout position; with net distributions of $220,000 for the quarter and investment returns were $233,900 for a net change of $13,930.

The Bond Market Fund was up 56 bps for the quarter. Their outperformance for the year was at 21 bps. This fund has been on watch list since February 2, 2004, and staff is very pleased with

its turnaround. The Cash Funds underperformed for the quarter and one-year, which generally happens in a rising interest rate market. The fund is outperforming the peer group. It is also outperforming the benchmark for the five-year year period. The TAP Option has outperformed for the quarter, one-, three-, five- and ten-year periods. The Long Horizon, Mid Horizon and Short Horizon, which we manage internally and are also on watch list, have outperformed for the quarter and one-year. Since being put on watch list, they have outperformed by 6 bps for the Short Horizon, 15 bps for the Mid Horizon and 14 bps for the Long Horizon. Some changes were made to the management of those funds and staff believes the outperformance will continue. The Socially Balanced Fund was down 52 bps but is now up 92 bps compared to the benchmark for the one-year period. Their performance has been good long term, but they experienced a challenging quarter.
The Equity Income Fund underperformed by 160 bps due to energy and financial holdings, the Independence Fund underperformed by 94 bps due to security selection (primarily in healthcare), and the Growth Company Fund underperformed by 135 bps due to holdings in the technology sector and their security selection in health care and discount airline companies. The U.S. Stock Market Index outperformed by 6 bps, U.S. Stock Fund outperformed by 2 bps, U.S. Large Stock Fund outperformed by 4 bps, and U.S. Small Stock Fund outperformed by 7 bps for the quarter. The Overseas Fund underperformed by 136 bps for the quarter. This is the last quarter for Fidelity in the Overseas Fund as they were replaced effective at the close of market on March 31, 2005. The underperformance was due to overweighting in the technology sector, stock selection in financials. The passive International Stock Fund outperformed by 6 bps.

**Daily Priced Investment Options**
Mr. Bruebaker said that the components of the daily priced investment options were included in the Deferred Compensation Program report.

**Labor and Industries' Funds**
The Labor and Industries' Funds were at $10 billion. The performance was positive for the quarter against the CMIs, benefiting from their CMO exposure and underweighting to the auto industry. The Accident Fund outperformed by 38 bps, Medical Aid Fund by 2 bps, Pension Reserve Fund by 44 bps, and the Supplemental Pension, ex-cash, outperformed by 7 bps.

In response to a question from Mr. Scott regarding the percentage of Plan 3 participants who have selected TAP option as their self-directed option in defined contribution, Mr. Bruebaker said that the percentage of TRS3 participants selecting the TAP option is 54 percent.

[Ms. Brookman was in attendance at 9:53 a.m.]

**Permanent and Other Trust Funds**
Mr. Bruebaker reported that the Permanent Funds had a challenging quarter, hurt by their underexposure to the longer end of the yield curve. He also reported that the cash returns in the Other Trust Funds also had a challenging quarter with only the Judicial Retirement and Reclamation Revolving funds outperforming for the quarter.

The Guaranteed Education Tuition (GET) portfolio was at $491.6 million, up $32 million for the quarter with all asset classes within their policy ranges. GET has outperformed by 10 bps for the quarter, is down for the one-year, even for the three-year, but is up 60 bps for the 5-year period.

The Developmental Disabilities Endowment Fund state portfolio was at $6.7 million. All asset classes are within their adopted ranges. The private funds portfolio was at $2.4 million, up $869,000 for the quarter. Performance was down 130 bps for the quarter, but is up for the one-year, three-year, and since inception.

**Private Equity**

Mr. Ruggels introduced Tara Blackburn and Mike Krems of Pacific Corporate Group (PCG), the Board's private equity consultant, who presented the private equity funds quarterly report for the period ended December 31, 2004.

Ms. Blackburn said that the private equity portfolio had a good fourth quarter. Commitments approved in 2004 were just over $1.3 billion. Quarterly contributions averaged about $500 million for the year. Contributions exceeded distributions, providing net cash to the system of $206 million for the quarter. The portfolio's internal rate of return (IRR) since inception was 14 percent as of December 31, 2004, up from 13.6 percent as of September 30, 2004.

Both the KKR and LP portfolios experienced a significant amount of appreciation during the quarter: $236 million in the KKR portfolio and $542 million in the LP portfolio. Two commitments totaling $135 million closed during the quarter. Three funds were fully liquidated and exited during the quarter.

Ms. Blackburn described the sub-sector allocation chart and reported that everything is within its range. Venture capital is on the low side of its range, which is expected for a while. In international, the unfunded commitments are on the low side of the range but there were some new commitments in 2005 that are not reflected in the 2004 numbers. The unfunded distressed markets allocation is a little low, but deals are anticipated. Ms. Blackburn said that the program continues to be well diversified across industries. The portfolio has outperformed its benchmark, the S&P 500 plus 500 bps, on a one-, three- and five-year basis.

[Senator Brown was in attendance 10:02 a.m.]

Ms. Blackburn reviewed the 2004 plan projections versus actual. Both contributions and distributions exceeded the plan. Distributions are expected to slow some in 2005.

Mr. Krems provided a market review of venture capital and buyout fundraising. Fundraising has started to rebound. Buyouts have experienced an increase, particularly in the fourth quarter of 2004. There has been a slight increase in capital invested in venture capital and a marked increase in buyouts. He reviewed exit opportunities commenting that IPOs have been a preferred exit route in the 1980s and 1990s, but there has been a recent switch to mergers and acquisitions. This has been fueled by lower interest rates and, in private equity, the recovery of corporate balance sheets and continued emergence of financial sponsors selling to other financial sponsors.

Treasurer Murphy asked Mr. Krems if there has been that type of activity occurring among the funds in which the WSIB is invested. Ms. Blackburn said this has occurred occasionally. Mr. Kaminski said he would like to know the amount of publicly traded stock still in the WSIB private equity portfolio. Ms. Blackburn responded that KKR had 24 percent of their holdings in public stock while the rest of the portfolio had 26 percent of their holdings in public equity. Treasurer Murphy said that he is interested to know what portfolio companies have been sold by one WSIB general partners to another WSIB general partner. Ms. Blackburn stated that she did not have that information with her but that she would be happy to follow-up with it.

Ms. Blackburn reviewed fundraising and market trends. A discussion ensued about distressed markets and how governance issues are dealt with among managers participating in "club" deals.

**Real Estate**

Mr. Draper reported on the performance of the real estate portfolio through December 31, 2004. The total current market value of the portfolio is $4.25 billion, which comprises 9.3 percent of the CTF. He said that the return for 2004 roughly doubled the long-term expectations for the asset class. Mr. Draper reported net returns were, 16.3, 13, 12.2 and 15.7 percent for the one-, three, five- and 10-year periods respectively. The NCREIF index, the benchmark used by WSIB and which is reported on a gross basis, posted returns of 14.5, 10, 9.9 and 10.9 for the same periods. He said that income returned 6.3 percent for 2004, which is good but he would like to see it higher, noting that this is not likely while the portfolio is in growth mode. Mr. Draper said that capital inflows to real estate were exceptional in both the U.S. and globally. This has influenced appreciation of property values, especially in the U.S. The WSIB has also benefited from strong performance in some foreign markets, with Japan, Korea, and Central Europe posting strong returns during 2004.

Mr. Draper reported that he recently toured properties in Florida with the Hometown America management team and continues to be exceptionally impressed with this partner. They posted a net return of 20.7 for 2004, and their IRR since inception is 21.7 percent. Principal Enterprise Capital (PEC), which is the largest real estate commitment made by the WSIB, returned 15 percent net in 2004, with a net IRR since inception of 18.6 percent. PEC also looks strong in 2005. Mr. Draper reported that within the five Lone Star funds the WSIB is invested, Lone Star IV returned 26.4 percent and Lone Star III returned 38.1 percent for 2004, which is due to their solid performing assets and the sale of a large asset they made late in the year in Korea. He said that they recently sold another large asset, from which the WSIB received $90 million profit from a single transaction. EuroInvest had a large number of their assets going through repositioning in recent years, and these business plans began to pay off in 2004, which resulted in returns of more than 19 percent last year. Central Europe was the main driver and staff is looking to do more in that area.

Mr. Draper said that the five largest real estate partners constitute two-thirds of the invested moneys. There was $4 billion in unfunded commitments at the end of 2004, which has risen to nearly $5 billion currently. Mr. Draper said this is a reflection of the patience of WSIB's general partners in a challenging marketplace.

Mr. Draper described the WSIB's property type and geographic diversification. He said that, overall, real estate continues to see remarkable capital inflows. The WSIB's general partners have exhibited excellent underwriting discipline, and long-term strategic partners are exceeding expectations.

In response to a question from Mr. Weeks regarding the Hawthorne Timber investment, Mr. Draper said that it was a specific strategy with timber holdings that has not fared well and is being sold. In response to a question from Mr. Hanna as to what extent currencies play in the high returns of the international holdings, Mr. Draper said that WSIB's investments were partially hedged, so it is not a significant factor.

## PUBLIC MARKETS COMMITTEE REPORT

Mr. Gorton reported on the U.S. Equity Enhanced Indexing education session at the May 3 Public Markets Committee meeting. State Street Global Advisors, Goldman Sachs Asset Management, and Barclays Global Investors participated in the session. Staff will bring a concept document for U.S. enhanced indexing to the June 7 Committee meeting.

## PRIVATE MARKETS COMMITTEE REPORT

### Private Equity

**Asia Opportunity Fund II, L.P.**

Ms. Brookman reported that the Private Markets Committee recommends an investment of up to $100 million in Asia Opportunity Fund II, L.P., a $1.1 billion fund being formed by J.P. Morgan Partners Asia Ltd., to do leveraged buyouts in Asia. If approved, this will be a new general partner relationship for the WSIB. The Committee's recommendation is based, in part, on the following: the multinational management team is strong, with complementary operational and financial skills; it has a successful, proven, pan-Asian strategy, and will focus on control investments in five core markets: Japan, Greater China, South Korea, Australia and Singapore. The performance of Asia Opportunity Fund, L.P., has been solid. The fund has invested $793 million and has already returned 85 percent of that invested capital as of December 31, 2004, producing a 14.1 percent net IRR and 1.39x net multiple. The fund is an excellent fit in the private equity portfolio and this opportunity would provide pan-Asian exposure in the private equity portfolio, a geographic region that is currently underweighted.

> **Ms. Brookman moved that the Board approve an investment of up to $100 million, plus fees and expenses, in Asia Opportunity Fund II, L.P., subject to continued due diligence and final negotiation of terms and conditions. Ms. Matheson seconded and the motion carried unanimously.**

**Elevation Partners, L.P.**

Ms. Brookman reported that the Private Markets Committee recommends an investment of up to $100 million in Elevation Partners, L.P., a private equity fund that will invest primarily in media, entertainment, and consumer-related businesses with a focus on content, intellectual properties and interactive entertainment. If approved, this will be a new general partner relationship for the WSIB. The Committee's recommendation is based, in part, on the following: the management team is talented and highly motivated with a unique combination of backgrounds, experiences,

and skill sets that support the fund's investment strategy; the co-founders have all demonstrated their talents as important contributors to other highly successful organizations and the team has an excellent balance of financial and operating skills. The fund will invest in niche sectors of the media and entertainment industries historically overlooked by traditional private equity investors. The general partner group has a strong network of relationships in the sectors where the fund will focus, providing unique access to a significant number of quality investment opportunities. The fund is an excellent fit in the private equity portfolio, having little overlap with other partners' strategies and this is an opportunity to establish a meaningful relationship with a promising new group with a unique profile and strategy.

> **Ms. Brookman moved that the Board approve an investment of up to $100 million, plus fees and expenses, in Elevation Partners, L.P., subject to continued due diligence and final negotiation of terms and conditions. Ms. Matheson seconded and the motion carried unanimously.**

[The Board recessed at 10:50 a.m. and reconvened at 10:58 a.m.]

## AUDIT COMMITTEE REPORT

Treasurer Murphy said that the Audit Committee met on May 10. He reported that the WSIB received its 13th consecutive clean audit from the State Auditor's Office for 2004.

### Fiscal Year 2005-2006 Audit Plan

Treasurer Murphy said that the internal auditor presented a plan for 2005. Scheduled audits include a review of the custodian bank, fixed income management, and the private equity consultant. An external review of the IT system consultant will be conducted.

> **Treasurer Murphy moved that the Board accept the Audit Committee's recommendation to approve the Fiscal Year 2005-06 Audit Plan. Ms. Brookman seconded and the motion carried unanimously.**

### Internal Audit Charter Policy 1.00.190 Revision

Treasurer Murphy reported that the proposed Internal Audit Charter Policy 1.00.190 revision remove references to governing auditing standards, which is appropriate since the WSIB does not receive federal funding.

> **Treasurer Murphy moved that the Board accept the Audit Committee's recommendation to approve the Internal Audit Charter Policy 1.00.190 revision. Ms. Brookman seconded.**

Ms. Matheson clarified that the recommendations were received from the Quality Assurance Team, which conducted a peer review of the WSIB's internal audit program.

> **The above motion carried unanimously.**

**Conflict of Interest Policy 2.00.100 Revision – Gift Reporting**
Treasurer Murphy said that the proposed Conflict of Interest Policy 2.00.100 revision modifies the gift reporting and monitoring procedures.

> **Treasurer Murphy moved that the Board accept the Audit Committee's recommendation to approve the Internal Audit Charter Policy 1.00.190 revision. Ms. Brookman seconded and the motion carried unanimously.**

Treasurer Murphy reported that the Audit Committee also received an education session on the Sarbanes-Oxley Act. He announced that Beth Vandehey is promoting within the agency and that an Audit sub-committee will participate with the internal auditor recruitment process. The August Audit Committee meeting is rescheduled for September 6, 2005.

## STAFF'S REPORT

**Executive Director's Report**
Mr. Dear provided his monthly report for May. He said a new Board member orientation would occur on June 14, 2005; all members are welcome to attend. Mr. Dear reported on staff, investments, operations, communications and legislation activities.

**Monthly Investment Report**
Mr. Bruebaker provided the CTF monthly investment report for May. For the month, U.S. equity lost 2.2 percent, but outperformed the index by 1 bp. U.S. equity underperformed by 1 bp for the year ended April 30. International equity lost 2.6 percent, underperforming the benchmark by 14 bps and 12 bps for the year ended April 30. The international program was restructured as of July 1, 2004, and has outperformed since that time by 51 bps. The CTF fixed income was up 1.3 percent, outperforming the Lehman Universal by 9 bps. The governments and credits outperformed the index, but the CTF was hurt by short duration and TIPS exposure. The one-year performance has outperformed the Lehman Universal by 21 bps.

Private equity was up 3.2 percent for the month. Draws were $243 million: KKR draws were $170 million and $73 million from the rest of the portfolio. Distributions were at $133 million, all of that coming from the LP portfolio. Four investments were closed during April. In Menlo Ventures X, the Board approved a $250 million investment but we only received $150 million due to the fund being highly oversubscribed. In Banc Funds VII, the Board approved a $50 million investment, but we only received $32.15 million in that fund. Real estate returned 2.2 percent for month. Draws were at $63 million in April. Distributions back to the portfolio were $27 million.

## ASSISTANT ATTORNEY GENERAL'S REPORT

Mr. Silver provided an update on the selection process for securities litigation attorneys. Firms resubmitted fee proposals, which the Office of the Attorney General will examine and determine a list of finalists. The goal is to get a roster of three firms for consideration if a securities litigation matter comes before the Board. A bid process would occur at that time. Treasurer Murphy suggested that Board members who have an interest in participating in the selection process should notify the executive director. Mr. Dear clarified that no litigation is currently pending that would require acquisition of these services at this time.

Mr. Silver said that he would discuss the WorldCom settlement terms in executive session.

Treasurer Murphy called the Board into executive session at 11:19 a.m. Mr. Silver said that the purpose of the session is to discuss litigation or potential litigation matters. He estimated that the executive session would last approximately 15 minutes. Treasurer Murphy said that, after completion of the executive session, the Board would resume its open public session.

[The executive session concluded and the Board recessed at 11:34 a.m. The Board reconvened in open session at 11:54 a.m.]

[Ms. Matheson was no longer in attendance at 11:56 a.m.]

Mr. Bruebaker provided members a copy of the unconstrained asset allocation numbers requested by Mr. Kaminski earlier in the Board meeting.

**EDUCATION SESSION – PLAN MATURITY: HOW DOES IT AFFECT YOUR ASSET ALLOCATION DECISION?**

Ms. Will introduced Allan Emkin of Pension Consulting Alliance and Bob McCrory of EFI Actuaries. She said that the firms had joined together to participate in this year's asset allocation study of the commingled retirement fund. Mr. McCrory provided his background and an overview of his firm. Mr. Emkin said that their study would provide choices from which the Board could make decisions that make sense for the portfolio.

Mr. McCrory reviewed pension plans at different stages in their lives—new, mature, declining—focusing on their asset allocation. He described how plans change as they mature, including differences in cash flows, compared assets to payroll, and detailed benefit payments. He discussed the importance of stability and the effect of smoothing techniques. Case studies of the benefits, funding ratios, and different allocation rates were discussed as they related to declining and mature plans.

A discussion ensued regarding factors that are not within the Board's control. Mr. Emkin said those factors would be taken into consideration. Mr. Dear said that the Board is part of a system and it is part of our task as fiduciaries to consider the impact that the WSIB's decision have on other parts of the system.

[Mr. Weeks was no longer in attendance at 12:55 p.m.]

**OTHER ITEMS**

There was no further business to come before the Board. The meeting adjourned at 12:56 P.M.

Treasurer Mike Murphy
Acting Chair

ATTEST

Joseph A. Dear
Executive Director