WASHINGTON STATE INVESTMENT BOARD
Board Meeting Minutes
June 16, 2005

The Washington State Investment Board met in open public session at 9:37 A.M. in the boardroom at 2100 Evergreen Park Drive SW, Olympia, Washington.

Present:	George Masten, Chair Pat McElligott, Vice Chair Debbie Brookman Glenn Gorton Jeff Hanna Charlie Kaminski Sandy Matheson Treasurer Mike Murphy Dave Scott Representative Helen Sommers Gary Weeks
Absent:	Senator Lisa Brown John Magnuson Bob Nakahara Jeff Seely
Also Present:	Joe Dear, Executive Director Gary Bruebaker, Chief Investment Officer Kristi Walters, Executive Assistant Paul Silver, Assistant Attorney General Dr. John Por, Cortex Applied Research, Inc. Tom Iannucci, Cortex Applied Research, Inc.

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

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

ADOPTION OF MINUTES – MAY 19, 2005

Treasurer Murphy moved to adopt the May 19, 2005, Board minutes. Vice Chair McElligott seconded.

Mr. Kaminski noted a correction on page 6. The second comment noted as being said by Treasurer Murphy was actually said by Mr. Kaminski. Mr. Bruebaker said that the numbers in the

minutes responding to Mr. Kaminski's question are accurate, but Pacific Corporate Group (PCG) is still working on a response to Treasurer Murphy's question about sales between GPs.

The minutes as corrected were approved unanimously.

[Mr. Weeks was in attendance at 9:40 a.m.]

PUBLIC COMMENT

There was no public comment.

ADMINISTRATIVE COMMITTEE REPORT

Agency Request Legislation

Chair Masten said that the Administrative Committee looked at potential agency request legislation.

Chair Masten moved that the Board accept the Administrative Committee's recommendation to move forward with Agency Request Legislation in the 2006 Legislative Session subject to review by the Office of Financial Management and the Governor's Office. Vice Chair McElligott seconded the motion.

Chair Masten said the proposed legislation clarifies the statute to afford voting members the same protection as nonvoting members and also clarifies a problem with daily valued funds. Mr. Dear said staff brought it forward as a result of the enterprise risk management project. The issue was also discussed several years ago by the Audit Committee. A second part of the proposed legislation extends immunity to voting members and staff provided they are acting within their fiduciary duty and within the law. Chair Masten asked that the executive director bring the issue back before the Board before legislation is introduced. Mr. Dear agreed.

The above motion carried with Chair Masten voting no.

PRIVATE MARKETS COMMITTEE REPORT – PRIVATE EQUITY CONSULTANT SELECTION

Ms. Brookman reported that PCG's contract to provide private equity consulting services to the Board expires on December 31, 2005. Accordingly, a Request for Proposals (RFP) was issued on February 15, 2005, seeking bids from qualified firms to perform private equity consulting services. The RFP was structured to allow firms to offer Category A services, which include consulting, deal sourcing, due diligence, and investment recommendation; Category B services, which include performance measurement, portfolio reporting, monitoring, and transaction management; or both. Staff received eight responses that were evaluated and scored on: depth, stability, and capacity of the organization; quality and experience of staff; customer service; investment philosophy and due diligence process; demonstrated success in accessing top-tier funds for clients; monitoring, performance measurement, and reporting capabilities; and transaction management and back office capabilities. After additional evaluation, which included reference checks and in-person interviews of the semi-finalists, staff invited two finalists to make presentations to the Private Markets Committee. The finalists were the

incumbent consultant, PCG, and Capital Dynamics. Both firms made proposals to offer both Category A and Category B services.

Following the presentations, the Committee had a significant discussion of merits and concerns relative to both firms and voted to recommend that the Board select Capital Dynamics as the apparently successful offeror to provide private equity consulting services.

> **Ms. Brookman moved that the Board accept the Private Markets Committee's recommendation to select Capital Dynamics, Inc., as the apparently successful offeror for the private equity consultant contract, subject to final negotiation of terms and conditions. Ms. Matheson seconded the motion.**

Ms. Brookman said that Mr. Seely, who is not present at today's meeting, supports the recommendation.

Treasurer Murphy stated his concerns that Capital Dynamics' home base is nine time zones away and the WSIB's primary contact was agreeable with moving to San Francisco, but not to Seattle. He said that he is not disappointed with the work done by PCG and wants to know why staff would go with a proposal that costs more. Treasurer Murphy said he would vote no.

Mr. Kaminski said that, during due diligence, PCG clients provided mixed references, which somewhat dovetails with the WSIB's experience. He said that Capital Dynamics has seasoned expertise overseas, which appears to be where the WSIB's future concentrates. The firm also received stellar references. Mr. Hanna agreed with Mr. Kaminski, adding that he does not feel that PCG has a lot of independent judgment and their recommendations tend to parallel those of staff. He said that it says a lot that staff is willing to go through the difficulty of changing consultants. Capital Dynamics appears to have more innovative research and has firepower at the new firm that would give the WSIB an edge.

Ms. Matheson said it appeared there were two pretty good options. Capital Dynamics is a firm that the WSIB would play a substantial role in its growth. Vice Chair McElligott said that, while he seconded the motion, he does have a few concerns with the size of Capital Dynamics, where the WSIB's primary staff contacts would locate, and that their fees are higher than PCG's. He said that he trusts the opinions of the two nonvoting members' to move to Capital Dynamics and noted that staff had put a lot of time into the process. If the Board agrees to move forward with Capital Dynamics, Vice Chair McElligott said that the Board's views should be shared as to where we want to see their office, time zone differences, and contact with these people.

Mr. Kaminski noted that Capital Dynamics has a risk tool that we have not found with the existing relationship, which will be important going forward in private equity and in taking a more quantitative approach with the asset class. Mr. Kaminski also inquired about the need for Capital Dynamics to formalize a code of ethics within their firm. Mr. Bruebaker said that the WSIB would not enter into the contract without a code of ethics. In response to Mr. Weeks' question as to what the WSIB would get for the additional money, Mr. Bruebaker said he believes that PCG would do an adequate job of servicing the WSIB account, but staff believes Capital Dynamics is better

positioned with their research capabilities to assist the WSIB in moving to the next level in analyzing its portfolio. Mr. Dear stated that he also believes the capacities noted earlier by Mr. Kaminski support the extra expenditure of funds for these services. Chair Masten said he believes it is a value to change consultants periodically.

The above motion carried with Treasurer Murphy voting no.

PUBLIC MARKETS COMMITTEE REPORT
Enhancements to U.S. Equity Portfolio – Request for Proposal Concept Documents U.S. Equity Enhanced Index Management

Mr. Gorton reported that the Public Markets Committee met on June 7 to consider three concept documents. The first two concept documents the Committee considered related to enhancements for the U.S. equity portfolio. Approval to issue the RFPs would allow staff to perform searches associated with enhanced indexing and fundamental metrics indexing. If approved, staff will work with Callan Associates to reach out to managers that may not otherwise respond to an RFP process. The Public Markets Committee would interview potential managers at the September meeting. Enhanced indexing is a risk-controlled form of active management that differs somewhat from the benchmark in an attempt to produce higher returns. While enhanced indexing does have a relatively low tracking error, there is more risk than passive indexing.

Mr. Gorton moved that the Board accept the Public Markets Committee's recommendation to authorize the issuance of a Request for Proposal for U.S. Equity Enhanced Index management consistent with the scope of services and terms of the concept document. Mr. Scott seconded the motion.

Mr. Masten clarified that this would not commit the Board to do the active management proposal, but allows the Board to examine managers that provide enhanced index strategies.

The above motion carried unanimously.

Enhancements to U.S. Equity Portfolio – Request for Proposal Concept Documents Fundamental Metrics Index Management

Mr. Gorton reported that fundamental metrics indexing utilizes an index based on weights derived from company fundamentals instead of market capitalization. If approved by the Board, staff will conduct a search for possible use of this product in both the U.S. equity and international equity portfolios.

Mr. Gorton moved that the Board accept the Public Markets Committee's recommendation to authorize the issuance of a Request for Proposal for Fundamental Metrics Index management for both U.S. and international services consistent with the scope of services and terms of the concept document. Mr. Scott seconded and the motion carried unanimously.

Request for Proposal Concept Document – Deferred Compensation Program and Judicial Retirement Account U.S. Equity Options

Mr. Gorton reported that the third concept document the Committee considered related to a search to determine the best managers for the U.S. active value and U.S. active core options in the Deferred Compensation Program and Judicial Retirement Account. The current options are on Watchlist due to underperformance.

> **Mr. Gorton moved that the Board accept the Public Markets Committee's recommendation to authorize the issuance of a Request for Proposal for U.S. equity options for the Deferred Compensation Program and Judicial Retirement Account consistent with the scope of services and terms of the concept document. Mr. Scott seconded and the motion carried unanimously.**

[The Board recessed at 10:10 a.m. and reconvened at 10:17 a.m.]

BOARD GOVERNANCE

Mr. Dear introduced the Board governance presentation. He said that having governance work well and be understood is important to the ability of the Board to accomplish its mission. He introduced Dr. Por and Mr. Iannucci from Cortex Applied Research, Inc. to provide an update and give their observations of previous work done by the Board in 2002 and throughout 2003, which resulted in a review of Board charters and fundamental policies. Mr. Iannucci, Managing Director, and Dr. Por, President, introduced themselves to the Board.

Mr. Iannucci noted the high level of stability among the Board's composition. He briefly described the differences between corporate and pension investment governance. He noted that the WSIB is among the progressive boards that identified the need to deal with governance a number of years ago, while other systems are just beginning to deal with it. Mr. Iannucci said that, to deal with it well, pension governance has to be an ongoing function that should be reviewed, revisited, updated, and discussed. Today is an opportunity to look at what has been done and what should be done in the future.

Mr. Iannucci said that Cortex had reviewed a year's worth of Board and Committee minutes and spoke with a number of members in preparation for today's presentation. Members' suggestions for the session included: orientation, fiduciary duty, Board versus staff roles, delegation and control, and corporate versus pension governance.

Dr. Por provided a review of recent issues in pension governance, including defined benefit (DB) versus defined contribution (DC) plans, independence of investment consultants, Board education, social/ethical investing/foreign policy, and opening public funds to the public. He said that the industry has identified that Board self-evaluation is necessary to be effective. A discussion ensued regarding DB versus DC plans and if the governance model is the same for both.

Dr. Por said that the Board appears to be quite happy with the education and orientation it receives. He noted that asset/liability issues, which are major governance issues, would be discussed at the July session.

Dr. Por provided interpretations of fiduciary duty of prudence and fiduciary duty of loyalty, and provided a breakdown of how to demonstrate prudence.

A discussion ensued regarding delegation, responsibility, and a suggestion made previously about having staff handle procurement processes. Mr. Iannucci said that Boards at the higher end of the market more comparable with the WSIB are delegating more to staff and have found more efficient ways to do things surrounding the selection process.

Mr. Iannucci went through a list of what makes a good Board member. Mr. Scott pointed out that educating the public on what the Board does could also be added to the list. A discussion followed regarding board and staff roles and responsibilities and the best focus for both. Cortex shared their view that effective board roles include risk management, policy and oversight; and staff roles include policy support, implementation and performance.

[The Board recessed at 11:58 a.m. and reconvened at 12:32 p.m.]

Mr. Iannucci said that delegation with control is key. Activities can be broken down into the following elements: policy, strategy, and implementation. Policy should rest with the Board and implementation with staff; strategy is a combination of both.

Mr. Iannucci reviewed Cortex's model of pension governance, which includes five basic areas: roles/responsibilities; fiduciary knowledge, policy framework, reporting/monitoring, and Board/Committee operations. The model was applied against the work that the Board completed two years ago. Cortex performed a review of the governance and investment policies, the underlying governance principles the policies were built upon, and the WSIB's current governance structure. The review also focused on some key elements from the current policies including: Board education, operations, self-evaluation, code of conduct, executive director performance evaluation, service provider selection, and monitoring and reporting. Cortex also reviewed the 2004 Board meeting minutes.

Mr. Iannucci said that he found a high degree of compliance across all policies. There are three compliance areas that could be strengthened: investment philosophy, summary list of reports, and quiet period provisions. Mr. Iannucci said that, with regard to quiet periods, while there is no evidence of violations, these should be noted within meeting minutes and through documenting contacts with any member not attending the meeting.

It was noted that a quiet period on RFP issuance of those approved at today's meeting starts tomorrow, Friday, June 17, 2005. A discussion ensured regarding advance notification of quiet periods and how members can be aware of which firms are participating. Mr. Dear said that discussion with existing service providers can occur, but not related to the particular

procurement. There is one staff contact point for firms participating in an RFP process. He said that staff has drafted a change to the current policy to make it clear.

Mr. Iannucci reviewed the responses to questions posed to the 11 Board members participating in the self-evaluation survey. There is some disagreement among members as to performance in the areas of: 1) familiarity with Board rules and policies, 2) reporting on stakeholder relations, 3) communications with Board/legislators/constituents, 4) adequate reporting on asset/liability management, and 5) regular attendance at Board meetings.

Mr. Iannucci noted that the areas of highest interest for future training priorities were asset allocation/asset mix, alternative investments, and portfolio risk management.

Mr. Iannucci reported on some other issues raised during the survey process, including the frequency of meetings, following investment plans, closure on the Board's role relating to liabilities, staff reports on board member referrals, and public statements.

Mr. Dear said that a personnel discussion is planned for executive session at the Board retreat, at which time members can discuss whatever they want, but staff hopes that governance and some action plans for these issues could also occur. Mr. Kaminski mentioned some best practices that were shared at a seminar he attended last week and said he would like some consideration of these.

STAFF'S REPORT

Executive Director's Report

Mr. Dear detailed plans for the July Board retreat. He provided his monthly report for June on board governance, staff, investments, operations, communications and legislation activities. Tripp Gantt, the new Investment Officer in Real Estate, was introduced.

[Representative Sommers was no longer in attendance at 1:53 p.m.]

Monthly Investment Report

Mr. Bruebaker provided the CTF monthly investment report for June. For the month, U.S. equity returned 3.8 percent, outperforming the benchmark by 1 basis point (bp), but underperformed by 3 bps for the year ended May 31. International equity returned 0.8 percent for the month, outperforming the benchmark by 20 bps, outperforming by 43 bps for the year and by 75 bps since restructured on July 1, 2004. Fixed income returned 0.9 percent, underperforming the Lehman Universal by 25 bps. The governments underperformed the index by 43 bps, the credits underperformed the index credits by 31 bps, and the portfolio was hurt by shorter duration and its TIPS exposure. The one-year performance has outperformed the Lehman Universal by 67 bps. Private equity lost 1.5 percent for the month. Draws were $103 million for the month, all of which came from the LP portfolio. The average draws for 2004 were $166 million. Distributions were at $193 million. KKR distributions were $62 million and $141 million of distributions were from the rest of the portfolio. This compares to the 2004 average of $225 million, which was an all time record high year in distributions. Elevation Partners was the only investment closed at $100 million. Real estate returned 3.5 percent for month. Draws were $94 million, compared to a

monthly average last year of $38 million. Distributions were at $278 million, compared to a monthly average last year of $118 million.

ASSISTANT ATTORNEY GENERAL'S REPORT

Mr. Silver provided an update on the Enron settlements, which have been announced in the press. Citigroup agreed to contribute $2 billion to the Enron settlement to address claims against them. Their offer needs to be approved by the lead plaintiff, the California Board of Regents, and by the class action judge. JP Morgan Chase also agreed to pay $2.2 billion, which takes the total settlement to-date in Enron to approximately $4.7 billion. More activities on the litigation are expected this fall. The internal directors are not expected to settle until after their criminal trials and liabilities are resolved.

In response to Treasurer Murphy's question, Mr. Silver confirmed that the current total amount of the settlement is approximately $4.7 billion and the agreement provides that the attorneys would get $500 million of that as approved by the court. Treasurer Murphy stated that agreement is outlandish and the Board should be incensed about that level of fees being paid to counselors to get our money back. Mr. Silver said he would pass on sentiments regarding the amount of dollars. Ms. Matheson noted that it is a difficult problem because the amount of recovery is unknown and perhaps different payment formulas could be considered. Treasurer Murphy noted this as something to consider in the upcoming process of selecting the stable of attorneys for potential future securities litigation.

OTHER ITEMS

Vice Chair McElligott distributed a news article written by Treasurer Murphy on social security benefits.

There was no further business to come before the Board. The meeting adjourned at 2:13 P.M.

George Masten
Chair

ATTEST

Joseph A. Dear
Executive Director