WASHINGTON STATE INVESTMENT BOARD
Board Meeting Minutes
December 15, 2005

The Washington State Investment Board met in open public session at 9:35 a.m. in the boardroom at 2100 Evergreen Park Drive SW, Olympia, Washington.

Present:	Pat McElligott, Chair Glenn Gorton Charlie Kaminski John Magnuson Sandy Matheson Bob Nakahara David Nierenberg Dave Scott Jeff Seely Representative Helen Sommers Gary Weeks
Absent:	Debbie Brookman, Vice Chair Senator Lisa Brown George Masten Treasurer Mike Murphy
Also Present:	Joe Dear, Executive Director Gary Bruebaker, Chief Investment Officer Janet Kruzel, Investment Officer – Private Equity Kristi Walters, Executive Assistant Paul Silver, Assistant Attorney General Scott Daniels, Conning Asset Management Kevin Cameron, Glass Lewis

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

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

OATH OF OFFICE

Chair McElligott administered the oath of office to David Nierenberg, who was appointed as a nonvoting member of the Board at the November 17 Board meeting. Mr. Nierenberg will serve the remaining term of office vacated by Jeff Hanna until December 31, 2005, and for a new three-year term until December 31, 2008. Chair McElligott noted that Mr. Nierenberg will serve on both the Private and Public Markets Committees.

ADOPTION OF MINUTES – NOVEMBER 17, 2005

> **Mr. Scott moved to adopt the November 17, 2005, Board minutes. Mr. Gorton seconded and the motion carried unanimously.**

PUBLIC COMMENT

There was no public comment.

ADMINISTRATIVE COMMITTEE REPORT

Executive Director Evaluation Process Discussion

Chair McElligott said that, based on a suggestion made by Mr. Kaminski at the Administrative Committee meeting, a revised evaluation form was distributed, which adds another assessment area. There were no further changes recommended by Board members. Chair McElligott said that the form would be sent to all Board members and asked to have completed forms returned directly to him within two weeks. The results will be discussed at the January Board meeting.

Proposed Senate Resolution

Mr. Dear reported that he and Liz Mendizabal met with State Senator Brian Weinstein and two of his constituents who are concerned with serious violations of human rights in Sudan are were asking for divestment. Senator Weinstein and his constituents were advised that the WSIB is taking steps to address the issue and, instead of mandating legislation, it was agreed that Senator Weinstein would draft and propose a Senate Resolution, commending the WSIB for those efforts. Mr. Dear asked that the Board support the Resolution, which addresses concerns without disruption to the Board's investment decision making process.

> **Mr. McElligott moved that the Board indicate its support for the proposed Senate Resolution which expresses legislative concerns for the issue and endorses the WSIB's efforts to ensure that we are not invested in companies engaged in business activities that support genocide and human rights violations in Sudan. Mr. Gorton seconded and the motion carried unanimously.**

PRIVATE MARKETS COMMITTEE REPORT – PRIVATE EQUITY INVESTMENT RECOMMENDATION – FISHER LYNCH CO-INVESTMENT FUND, L.P.

Ms. Matheson reported that the Private Markets Committee met on December 1, 2005, and discussed an investment recommendation of up to $250 million, plus fees and expenses subject to continuing due diligence, in Fisher Lynch Co-Investment Fund, L.P., a $525 million customized co-investment fund being created specifically for the Oregon Investment Council (OIC) and the WSIB. The fund will primarily seek attractive co-investment opportunities offered by funds in the OIC and WSIB portfolios, although up to 20 percent of the fund may be invested in co-investments sponsored by funds not in the OIC or WSIB portfolios. The Committee's recommendation is based, in part, on: 1) the investment team's substantial private equity and co-investment experience. The principals invested $8 billion in private equity. They have invested $676 million in 22 co-investment transactions while employed by the Government of Singapore (GIC) between 1999 and 2003. 2) The co-investments have produced a strong track record, with an aggregate 17 percent net internal rate of return during a very challenging investment period. 3) Co-investments can substantially improve investment economics and are generally made free of sponsor management fees and carried interest. Also, the Fisher Lynch Capital management fees and scaled carried interest were the lowest proposed during the manager search process; and 4) the investment is an excellent fit in the portfolio, as it is the first co-investment initiative for the WSIB and will not compete with any existing manager.

Ms. Matheson moved that the Board accept the Private Markets Committee's recommendation to invest up to $250 million plus fees and expenses in Fisher Lynch Co-Investment Fund, L.P., subject to continued due diligence and final negotiation of terms and conditions, Mr. Scott seconded the motion.

In response to Mr. Seely's question, Mr. Bruebaker said that Oregon approved the deal last week.

The above motion carried unanimously.

LABOR AND INDUSTRIES' FUNDS ANNUAL PRESENTATION

Mr. Daniels of Conning Asset Management introduced himself to the Board.

Mr. Daniels provided an overview of the Labor and Industries' (L&I) Accident, Medical Aid, Pension Reserve and Supplemental Pension Funds, which are managed as separate portfolios. As of September 30, 2005, the consolidated portfolio was comprised of 82 percent fixed income and 18 percent equities. The cash, bonds and stocks within the portfolio support L&I's need for paying benefits, providing income, cash flow and long-term appreciation. L&I's investment strategy addresses the unique needs of a workers' compensation insurer.

Mr. Daniels described the portfolio objectives, which are to maintain the solvency of the funds, maintain premium rate stability, ensure sufficient assets are available to fund the ultimate liabilities and, subject to these objectives, earn a maximum return at a prudent level of risk. He said that total return is not L&I's primary objective. Returns in the three major funds have been good, between 7.5 and 8.5 percent. The change in duration target has caused the fund to lag the Comparable Market Indices (CMIs), which are used like a benchmark. CMIs included a blend of Lehman Government and Credit Indices, and the Wilshire 5000 and MSCI EAFE equity indices.

A discussion ensued regarding the impact of a recent court case on Accident Fund reserves. Mr. Weeks said that time loss benefit calculations must now include employer-paid health care costs. Previously this calculation included only wages and cash benefits. The Medical Aid Fund was unaffected by the decision.

Mr. Kaminski noted the Board's recent decision to equally weight U.S. and international equity in the Commingled Trust Fund (CTF), and said it might be worthwhile to look at the split within L&I's portfolio to see if it should also be adjusted. Mr. Bruebaker said that staff would look at the return and volatility to determine if it would make sense to change L&I's equity allocation.

Mr. Daniels reviewed L&I's financial statements as of June 30, 2005. A discussion ensued regarding rate stability and the affect of low interest rates.

Mr. Daniels explained the peer analysis data sources and assumptions. The peer group is comprised of both state funds and private insurers. Compared to its peers as of 2004 year end, L&I had high benefits, low expenses, and high investment income. Mr. Weeks reported that Washington State is 4th in the nation for benefits offered and 35th for rates paid by employers.

[The Board recessed at 10:45 a.m. and reconvened in open session at 11:00 a.m.]

ECONOMICALLY TARGETED INVESTMENTS ANNUAL REPORT

Mr. Dear said that that the economically targeted investments (ETI) policy adopted in 2003 calls for an annual report to the Board. Ms. Kruzel introduced herself to the Board. She said that the Board's ETI policy approach is very thoughtful and details the program objective and parameters to examine in considering investments. She described the Board's process for identifying ETIs, which are defined as investments having the primary objective to produce investment return to pension fund assets with a collateral objective of assisting the regional economy or the economic well-being of Washington State, its localities, and residents.

Ms. Kruzel reported that the WSIB hosted a funding forum in October, inviting 70 individuals from policy making and investment communities to participate in a discussion of funding sources for start-up and expanding Washington businesses. Ms. Kruzel reported there was great discussion among the 41 participants and the WSIB received positive feedback. She described other ETI activities occurring in 2005.

Ms. Kruzel reported that 97 percent of WSIB's general partners (GPs) responded to the third annual poll regarding their investment activities within Washington. Ms. Kruzel reported that 46 GPs looked at 1,223 Washington-based opportunities, 15 GPs did 33 deals, 30 of those were new and 3 were some level of follow-ons.

Ms. Kruzel reviewed U.S. venture capital investing for the fiscal year ended June 30, 2005. Over $21 billion was invested in U.S. venture capital deals. The Life Sciences sector continued its dominance, with the Software industry remaining the largest single category. The Northwest captured approximately 4 percent of the dollars invested in the U.S., with Washington capturing 83 percent of the Northwest dollars or 3.3 percent of the U. S. total. For perspective, it is helpful to look at the region in terms of its relationship to the Gross State Product (GSP); the Northwest region is about 4 percent and Washington is 2.2 percent of the 2004 U. S. National GSP.

Ms. Kruzel reviewed Washington investments in the CTF. Within private equity domestic investments, Washington-based deals comprise 1.4 percent of the total portfolio or $66.7 million, which is spread out among 57 different funds with 31 individual GPs, and diversified among 7 industries. She said that Washington State has many tremendous companies that offer good investment opportunities.

Ms. Kruzel described the chart showing the amounts invested and distributed and the remaining value of dollars invested in Washington, which were grouped and illustrated by the vintage year of the investment. The overall return multiple on dollars invested since 1996 in Washington is 1.09 times. She noted that, out of 57 funds (primarily venture capital), 7 funds have produced two-thirds of the total distributions.

A discussion ensued regarding the past experience with Washington-based companies compared to private equity investments overall and the related returns, and whether consideration of this could be taken into account when the Board considers future investment opportunities with regional managers.

Ms. Kruzel stressed that private equity manager selection is critical. She reviewed Washington investments made by WSIB GPs, noting that, within the 57 funds, Washington may represent as little as one investment within any single fund. Twenty-eight of the funds have less than a 1 times return, 22 have a 1 to 3 times return, and only 7 funds have a return multiple greater than 3 times.

Six of those 7 funds have greater than a 7 times return. In response to Mr. Kaminski's question about the number of Washington or Northwest venture capital general partners that the WSIB or its discretionary venture capital managers has invested with over the three years, Ms. Kruzel said there were none.

Going forward, Ms. Kruzel said that the WSIB would continue its outreach efforts, focus on relationships, and collaborate with local, state, and regional organizations and networks.

STAFF'S REPORT

Executive Director's Report

Mr. Dear provided his monthly report for December on Board, investments, operations, communications, and legislation activities.

2005 Strategic Plan Results

Mr. Dear said a report on Board and staff 2005 accomplishments was included in the Board packet. Mr. Dear said that it was a very good year.

[The Board recessed at 12:05 p.m. and reconvened in open session at 12:29 p.m.]
[Mr. Seely, Mr. Nakahara, Mr. Weeks, and Mr. Masten were no longer in attendance at 12:29 p.m.]

Monthly Investment Report

Mr. Bruebaker provided the CTF monthly investment report for November. For the month, U.S. equity earned 4.1 percent, outperforming the benchmark by 15 basis points (bps) and 10 bps for the year ended November 30, 2005. International equity returned 3.1 percent, underperforming its benchmark by 20 bps for the month and 2 bps for the year, which was mostly due to our underweight position in emerging markets while we wait for the conclusion of the outstanding RFP process to hire additional emerging markets managers. Fixed income returned 5 bps, underperforming the Lehman Universal by 2 bps. Private equity returned 5.5 percent for the month. Draws were $332 million: $224 million from KKR and the balance coming from the LP portion of the portfolio. Distributions were at $237 million: KKR distributions were $64 million and $173 million of distributions was from the rest of the portfolio. In November, Nordic Capital VI was approved and Avenue Special Situations IV was approved and closed. Real estate returned 2 bps for the month. Draws were at $54 million and distributions were $18 million.

CORPORATE GOVERNANCE EDUCATION SESSION

Mr. Cameron introduced himself to the Board. He said that the Board holds over 5,000 equities in its portfolio and votes proxies each year as part of its fiduciary responsibilities. He said that Glass Lewis provides WSIB staff with recommendations on every proposal within proxies. Mr. Cameron complimented the hard work of WSIB staff. He said it is unprecedented for a pension fund to pull in the proxy voting responsibilities in such a time efficient and effective manner.

Mr. Cameron reported on key policies considered in voting the 2005 proxies, which were: 1) board independence; 2) compensation that is reasonable and commensurate with performance; 3) separation of the chair and chief executive officer; and 4) ratification of auditors.

Mr. Cameron reported that the WSIB withheld votes from 4,850 (21 percent) of the 23,100 board of director elections this year. He said that the most common reason was due to the lack of board independence (the "two-thirds" rule). Other reasons were due to compensation practices, problems with the board fulfilling its fiduciary responsibilities, and existing or past legal and accounting

problems. Mr. Cameron provided a few examples of WSIB withheld votes, noting the issues, key facts and Glass Lewis' recommendation to staff.

Ms. Matheson asked what percentage of shareholders are institutional investors and if they create any impact on director elections. Mr. Cameron acknowledged that the percentage would vary by company but, across the industry, he estimated that institutional investors comprise about 62 percent. He said that, while institutional investors may not be able to affect change within some companies due to insider ownership, shareholder "no" votes send a message of investor dissatisfaction. It is worthwhile to consider other tactics and goals to alter company practices.

Mr. Cameron reported that the WSIB voted against 304 (25 percent) of approximately 1,200 compensation plans proposed this year due to its policy of having executive compensation linked to performance.

Representative Sommers said that she assumed that these companies' compensation plans were passed despite our efforts. She asked how WSIB's votes compared with other states. Mr. Cameron said that a majority of state pension funds have comparable voting records and approximately 45-50 of the proposed compensation proxies failed by virtue of no votes. He suggested that votes could be picked up from outside money managers to increase percentages.

In response to a question from Ms. Matheson, Mr. Cameron said that matrixes are used to deal with the issue of long-term investments against short-term performance, with the average CEO appointment lasting only three years. Examples of performance and pay analyses were discussed.

Mr. Cameron said that majority voting for director elections is expected to be an issue in 2006. He described frustrations with current practices, historical attempts by shareholders for change, and different company approaches to majority voting.

ASSISTANT ATTORNEY GENERAL'S REPORT

Mr. Silver said there was nothing to report.

OTHER ITEMS

There was no further business to come before the Board. The meeting adjourned at 1:09 p.m.

Pat McElligott
Chair

ATTEST

Joseph A. Dear
Executive Director