WASHINGTON STATE INVESTMENT BOARD
Board Meeting Minutes
February 16, 2006

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:	Pat McElligott, Chair Debbie Brookman, Vice Chair Senator Lisa Brown Glenn Gorton Charlie Kaminski John Magnuson George Masten Sandy Matheson Treasurer Mike Murphy Bob Nakahara David Nierenberg
Absent:	Dave Scott Jeff Seely Representative Helen Sommers Gary Weeks
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 Michael Humphrey, Courtland Partners Joseph Cook, Courtland Partners

[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. Due to a lack of quorum, action items were deferred until later in the meeting.

PUBLIC COMMENT
There was no public comment.

QUARTERLY PERFORMANCE REPORTS

WSIB Managed Funds

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, 2005, were provided to members. Mr. Bruebaker said he would focus on capital markets and investment performance in active strategies.

Large cap, as measured by the Russell 1000, earned 2.1 percent for the quarter, outperforming small cap, measured by the Russell 2000, by almost 100 basis points (bps). GDP growth dropped to 1.1 percent for the quarter, but was up 3.5 percent for the year. Inflation, as measured by the CPI, was down –0.4 percent for the quarter, but up 3.4 percent for the year. The Wilshire 5000 was up 2.2 percent for the quarter and 6.4 percent for the year. Within the public markets indices, growth outperformed value by 170 bps for the quarter. The ACWI ex U.S. outperformed U.S. markets by 217 bps for the quarter. For the year, value outperformed growth by 170 bps and the ACWI ex U.S. outperformed U.S. markets by 1,070 bps.

Mr. Bruebaker described the yield curve, which is inverted from the two year to the 30 year. He said that recessions have followed in some of the past years when the yield curve became inverted. This is a warning sign and has shown to be a good predictor of slowdowns in the past. He said that WSIB fixed income strategy going forward would be data dependent, based on trends in the economy and inflation, as well as interest rates and spreads.

Mr. Bruebaker explained the new implementation value added (IVA) benchmark, which combines the Board's allocation decisions and manager decisions. He said he feels it is the best benchmark as well as the toughest to outperform. Mr. Bruebaker then discussed the CTF investment performance compared to the performance of the Trust Universe Comparison Service (TUCS). He reported that the allocation decision hurt in every period, underperforming by 13, 76, 118, and 201 basis points (bps) for the quarter, one-, three- and five-year respectively. Mr. Bruebaker noted that the reason for this underperformance was that the best performing asset classes, real estate and private equity, have been underallocated. Private equity is almost at its target. Real estate is significantly below target, but staff is moving toward it according to the allocation plan approved by the Board. He reported that manager performance helped in every period, adding 74, 341, 91, and 258 bps. He noted that the median of each asset allocation target was used in the benchmark.

For U.S. equity, the WSIB underperformed for the quarter and five-year by 5 bps each, but outperformed in the one-, three- and ten-year periods by 5, 6, and 7 bps, respectively. International equity underperformed in all time periods as of December 31, 2005, due to being underweight in emerging markets at the wrong time. Mr. Bruebaker reviewed the quarterly performance of the international equity managers. Developed markets returned 3.9 percent; emerging markets returned 7.2 percent. Mr. Bruebaker reviewed the individual performance of the international developed markets enhanced index portfolios, active core, active value, and active growth managers.

For growth managers, Julius Baer underperformed by 20 bps. William Blair performed the best, outperforming by 310 bps. The total fund was under the benchmark of 3.9 percent at

3.8 percent. For emerging markets managers, Capital International outperformed by 280 bps, F&C underperformed by 30 bps, and GMO outperformed by 220 bps. Mr. Bruebaker said that, after looking at the cost of a transition manager, staff decided to wait until a new manager was hired to replace F&C so monies did not have to be transitioned twice. Overall, emerging markets managers returned 9 percent, versus the benchmark at 7.2 percent.

Fixed income continues to have excellent performance. There is $20 billion in assets under management. It outperformed in every time period by 9, 37, 56, 58, and 25 bps, respectively.

For defined contribution, the bond fund outperformed by 19 bps for the quarter and 89 bps for the year. Cash funds continue to underperform as short-term interest rates continue to increase.

For the balanced funds performance during the quarter, the Long Horizon Fund was even and the Mid and Short Horizon funds outperformed, helped by the bond fund. The Social Balanced Fund outperformed by 81 bps, helped by its equity allocation.

In the active U.S. equity, Fidelity's active strategies performed well for the quarter due stock selection, outperforming by 183 bps for equity income, 181 bps for the Independence Fund, and 324 bps in growth. Mr. Bruebaker announced that next quarter's report would include new managers. All passive U.S. equity options are within their expected range at -6 and +2 bps.

In active and passive international, active is outperforming by 24 bps due to stock selection; passive international underperformed by 4 bps.

Private Equity

Mr. Ruggels presented the private equity funds quarterly report for the period ended September 30, 2005. He said his report would highlight information from Pacific Corporate Group's written report. Commitments authorized for the quarter, including Vestar Capital Partners V and OCM Opportunities Fund VI, totaled $130 million. These funds also closed in September, as did KKR European Fund II and Asia Opportunity Fund II, with closed commitments totaling $730 million.

Mr. Ruggels described the contribution, distribution, and appreciation (depreciation) activity, as well as unfunded commitments within the KKR and LP portfolios during the quarter. The IRR since inception for the total portfolio increased by two-tenths of a percent during the quarter, from 14.3% to 14.5%. There was positive performance in every quarter during the past year. The portfolio valuation was approximately $7.8 billion as of September 30, 2005, with consistent quarterly draw and distribution activity throughout the year. For the year ended September 30, 2005, draws totaled $1.9 billion and distributions were $2.6 billion, creating a positive cash flow of $650 million. Appreciation for the year was $2.22 billion.

Mr. Ruggels reviewed performance of the KKR, LP, and combined portfolio. KKR returned 15.8 percent for the quarter and 50.0 percent for the one-year period. The LP portfolio returned 5.9 percent for the quarter and 32.2 percent for the one-year period. During more recent time periods, the LP portfolio has been hurt by the underperformance of the venture capital sub-class. The combined return of the portfolio outperformed the S&P 500 + 500 bps benchmark for the quarter, one-year and five-year periods. However, for the three-year and ten year periods, the performance fell short of the benchmark, outperforming the S&P 500 return by 350 bps and 490 bps, respectively. The portfolio returns are somewhat of an apples and oranges comparison.

Mr. Ruggels reviewed sub-sector performance and target allocations by strategy. He said that all strategies are within their range when looking at total potential exposure. He said that venture capital exposure is at the bottom of the range and it will be difficult in the future to keep venture capital within its current range, given the difficulty of putting large amounts of capital to work in quality venture capital opportunities.

Real Estate
Mr. Draper reported that the WSIB was successful in buying out the other shareholders of Corporate Properties of the Americas (CPA) during the third quarter 2005; the company is now owned jointly by the WSIB and the CPA management team. CPA's quarterly return reflects the payout of carried interest to the previous Managing Members, since this transaction represented a realization of the previous partners' deal. Staff feels positive about the relationship going forward.

Mr. Draper introduced Mr. Humphrey and Mr. Cook of Courtland Partners to report on the third quarter performance of the real estate portfolio. Mr. Cook reported that the quarter and year period ended September 30, 2005, was strong with solid returns. The total gross return was 6.2 percent for the quarter and 29.9 percent for the year. The net return was 4.6 percent for the quarter and 26.0 percent for the year. The net returns for the three-, five- and ten-year periods were 15.8, 14.0, and 16.5 respectively. Mr. Humphrey said that, while performance is at top or beyond the expectation level, Courtland has concerns about sustainability of real estate returns.

Mr. Cook referenced the summary of portfolio investment net returns. Mr. Cook noted that the many of the WSIB's larger real estate investments are among the best performers, most having double-digit returns. Mr. Humphrey noted that the one-year stellar net return of 117 percent in Lone Star III was due to its Asian exposure and, in particular, interest held in a Japanese bank. Mr. Kaminski noted that the Lone Star funds have had substantial write-ups and realizations. He said that the Board took advantage of investing in Japanese real estate at the right time, for the right reasons. Mr. Nierenberg referenced a recent *New York Times* article on investments in Germany. Mr. Draper advised that several WSIB partners are targeting the German market.

Mr. Humphrey detailed the WSIB's gross returns overall and by type (core, growth, opportunistic), which outperformed the NCREIF benchmark and Courtland database for all periods. During the quarter, the portfolio had $335 million in contributions, $309 million in distributions, and net income and appreciation of $204 million.

[Mr. Masten and Senator Brown were in attendance at 10:27 a.m.]

Mr. Humphrey reviewed historical cap rate declines by property type, which illustrate a decline of 300 bps since 2002-2003. It reflects how much pricing has changed in real estate, which is directly related to the large amount of capital entering the asset class. He said that the primary source of this capital is domestic, but there are strong cash flows from Europe as well.

Mr. Humphrey reviewed cash flows of real estate in the marketplace, detailing the NCREIF index's income component versus the 10-year Treasury yield. The gap in return premium between the two is growing smaller and, regarding cash yield, is basically gone.

Mr. Humphrey reported that Courtland believes that cap rates will begin to go up and have a negative effect on value, although improving real estate fundamentals, such as declining vacancy, may offset the negative effect of increasing cap rates. He said that Courtland believes the forecast for real returns looking forward will be in the 5 to 7 percent range. He reported that the WSIB is looking to take advantage of non-traditional markets and shift away from where capital is currently focused.

A discussion ensued regarding leverage governance and REIT privatization opportunities.

In response to a question from Mr. Nakahara, Mr. Humphrey said that regular conversations are held with staff about selling properties and asset valuations. He noted that the portfolio is turning over at a rate of every 4 to 5 years, which is a healthy pace. There have been some discussions on holding certain assets. Mr. Draper said that the goal of the WSIB's real estate program is to create a long-term, high-quality, stable income stream and that selling for a one-time profit is not the goal of the portfolio or the CTF. He noted that, because of this goal, once we own high-quality assets, we tend not to want to sell them.

Chair McElligott announced that Vice Chair Brookman was leaving the Board and today's meeting would be her last. He presented a letter of appreciation (copy attached) and clock to Vice Chair Brookman.

[The Board recessed at 10:45 a.m. and reconvened in open public session at 10:55 a.m.]

Chair McElligott announced that a quorum was present.

ADOPTION OF MINUTES – JANUARY 19, 2006

> **Treasurer Murphy moved to adopt the January 19, 2006, Board minutes. Mr. Gorton seconded and the motion carried unanimously.**

PUBLIC MARKETS COMMITTEE REPORT – ACTIVE GLOBAL EMERGING MARKETS INVESTMENT MANAGEMENT SELECTION

Mr. Gorton reported that the Public Markets Committee met on February 7 to interview managers for the emerging markets mandate in the CTF and to receive the annual reviews for the internally managed fixed income portfolios and Horizon Funds.

The Board's recent asset allocation decision increased the CTF's international equity allocation from 15 percent to 23 percent. Within that allocation, the 2006 target for dedicated emerging markets is 7 percent. An RFP was issued for additional emerging markets managers and interested firms provided their information to Callan Associates. Callan then screened the responses against the minimum qualifications and WSIB staff and the Callan Manager Search

Committee further evaluated qualifying firms. WSIB staff then performed additional analysis and interviewed the top five firms. The Public Markets Committee interviewed the top three firms and concurred with staff's recommendation that the Board select all three managers.

Mr. Gorton moved that the Board accept the Public Markets Committee's recommendation to select Lazard Asset Management, J.P. Morgan Asset Management, and Pictet Asset Management as the apparently successful offerors for the Active Global Emerging Markets Investment Management mandate, subject to continued due diligence and successful negotiation of terms and conditions. Vice Chair Brookman seconded and the motion carried unanimously.

PRIVATE MARKETS COMMITTEE REPORT – PRIVATE EQUITY INVESTMENT RECOMMENDATIONS

Mr. Masten reported that the Private Markets Committee met on February 2 to discuss two investment recommendations.

OVP Venture Partners VII, L.P.

Mr. Masten moved that the Board accept the Private Markets Committee's recommendation to invest up to $40 million, plus fees and expenses, in OVP Venture Partners VII, L.P. subject to continued due diligence and final negotiation of terms and conditions.

Mr. Masten said that the Committee recommends an investment of up to $40 million in OVP Venture Partners VII, L.P. based, in part, on the following: 1) The investment team members have over 50 years of venture investing experience and share strong operating expertise with complementary backgrounds, enhanced with a veteran technology advisory group and in-house marketing and research expertise. 2) Since 1994, OVP has focused on leading or co-leading seed and early-stage IT investments primarily in the Northwest region. Regional knowledge and specialization distinguish OVP, which has developed substantial strategic relationships and alliances to achieve attractive first-look opportunities for their "early-in" position. 3) Since 1994, the firm has invested more than $301 million in over 60 early-stage companies, producing an aggregate net IRR of 12.4 percent, including $347.4 million in realizations and a net value multiple of 1.2x. The two fully realized funds have produced solid returns and value multiples greater than 2x. 4) The venture sub-class is currently underweighted in the portfolio. OVP's regional, early-stage venture focus is an attractive fit in the portfolio and has minimal overlap with the strategies of other WSIB partners.

Vice Chair Brookman seconded the motion.

Treasurer Murphy announced that he voted no on this recommendation at the Committee meeting. He said that while OVP Fund IV, which the WSIB had invested in through INVESCO, has had stellar performance, the performance of the subsequent Fund V is dismal and it is too early to tell how Fund VI will perform. He does not want to do anything further until the performance Fund VI is known.

The above motion carried, with Treasurer Murphy voting no.

KKR 2006 Fund, L.P.

Mr. Masten moved that the Board accept the Private Markets Committee's recommendation to invest up to $1.5 billion, plus fees and expenses, in KKR 2006 Fund, L.P. subject to final negotiation of terms and conditions.

Mr. Masten said that the Committee recommends an investment of up to $1.5 billion in KKR 2006 Fund, L.P. based, in part, on the following: 1) KKR has a strong and consistent performance record, achieved through multiple investment cycles, with substantial cash realizations. Since 1983, the aggregate return of all WSIB investments with KKR has been 17.0 percent, with a net multiple of 1.85x. 2) The KKR management team is deep and experienced, with 64 investment professionals, 23 of which are Members (partners) of the firm. The six most senior members of KKR have worked together for 20 years. 3) KKR's proven strategy emphasizes value creation post-investment by improving the operating performance of portfolio companies. This operational focus leverages the firm's extensive resources, including internal industry teams, strategic advisors, and Capstone Consulting, a consulting firm providing services exclusively to KKR companies. 4) KKR has a strong franchise, reputation, and network of industry relationships that gives the firm a competitive advantage in deal sourcing, transaction execution, and access to superior management talent, both within the firm and at the portfolio company level. The firm's strong brand is being extended globally. 5) This is an opportunity to expand a successful, long-term relationship with a high-quality partner.

Treasurer Murphy seconded the motion.

Mr. Masten announced that he would vote no on the recommendation. He said that he believes the WSIB is missing an opportunity to invest a higher amount and expand its relationship with a proven partner, with a proven record, and this decision would hurt beneficiaries. Mr. Masten pointed out that lower fees were given up because of the recommended level.

Mr. Nierenberg said that he would like the WSIB to have an opportunity to invest in the KKR Asia Fund, expected to be raised next year, as it would be worthwhile geography to diversify holdings. He suggested that the total size of the relationship could be considered at that time.

Ms. Matheson noted that this long-time partner has helped the WSIB portfolio grow. She reported that there was extensive Committee discussion about the recommended amount and reasons for its level. She suggested that the Board may want to have a future discussion regarding the merits of a larger investment to demonstrate that the WSIB is also a good partner. Ms. Matheson asked about co-investment opportunities with KKR. Mr. Dear said that co-investment opportunity was discussed, but was not included in the terms for a commitment at this level. He said that KKR co-investment opportunities could be an open item for future work.

Treasurer Murphy said that he supports $1.5 billion for the KKR 2006 Fund. He reminded members that he voted no on KKR's last proposal, and had put a lot of thought and consideration into his decision to vote favorably. He pointed out that, if the recommendation is approved, the

WSIB would have a combined exposure of $4 billion with this partner, which represents an 8 percent exposure in the CTF with one firm. He agreed that KKR has had stellar performance over a number of years, but said that the concentration risk is significant. He said that $1.5 billion is reasonable and acceptable.

A discussion ensued on the proposed terms including fees, the possibility of co-investment opportunities, commitment size, asset allocation levels, and exposure opportunities.

Mr. Kaminski said that he supports staff's recommendation. Chair McElligott said that he was in favor of a higher amount. He asked staff to promptly determine if an additional commitment would be required for co-investment opportunities.

The above motion carried, with Mr. Masten voting no.

[Senator Brown was no longer in attendance at 11:35 a.m.]

AUDIT COMMITTEE REPORT

Treasurer Murphy said that the Audit Committee met on February 7.

Internal Audit Report 2006-01, Fixed Income

Treasurer Murphy reported that the Committee received an internal audit report of the internally managed fixed income investment unit. The overall assessment of fixed income management was good; staff is complying with fixed income investment policies and transactions are properly documented, reviewed, and authorized. One control risk was identified and a recommendation to management was made to have Savings Pool investments monitored for compliance independent of the investment function, with Operations staff developing and documenting procedures to monitor compliance with Savings Pool guidelines.

Treasurer Murphy moved that the Board approve the Audit Committee's recommendation accept Internal Audit Report 2006-01, Fixed Income. Mr. Gorton seconded and the motion carried unanimously.

Fiscal Year 2005 State Audit Report

Treasurer Murphy reported that the WSIB received another clean audit from the State Auditor's Office for fiscal year 2005. This is the 14th consecutive clean audit report. He commended staff on their fine work in continuing to achieve clean audits.

Proxy Voting Policy 2.05.200 Proposed Revision

Treasurer Murphy said that Glass Lewis & Co. had recommended a change to the Board's Proxy Voting Policy 2.05.200. The proposed change states that the WSIB will support shareholder and company proposals for a majority vote standard requiring that directors must receive a majority of votes cast to be elected. This would allow shareholders to collectively vote to reject a director they believe does or will not pursue their best interests.

Treasurer Murphy moved that the Board accept the Audit Committee's recommendation to approve the Proxy Voting Policy 2.05.200 revision, to

include Election of Directors by Majority Vote. Mr. Gorton seconded the motion.

Treasurer Murphy added that, should the Board vote positively on the motion, he had asked staff to send copies of the revised policy to the largest companies in the index to make them aware of the change and encourage them to follow it.

Mr. Nierenberg described the current voting process which allows director nominees to be elected by only one vote. There is no method of voting no; shareholders can only withhold votes to show non-support. He said the policy revision is a proactive move for the Board, which he supports. He added that it is wonderful to have the WSIB take a leadership position on the issue.

The above motion carried unanimously.

Treasurer Murphy said the Committee also received the quarterly Internal Audit Recommendation Status Report, a status update on proxy voting, an annual report on daily valued funds, and received an education session on the agency's Enterprise Risk Management program.

STAFF'S REPORT

Executive Director's Report

Mr. Dear provided his monthly report for February on Board governance, staff, investments, open procurements, operations, and communications activities. Mr. Dear responded to questions from the Board regarding House Bill 2422, which creates a new maintenance account for state parks to be managed by the WSIB.

Monthly Investment Report

Mr. Bruebaker provided the CTF monthly investment report for January 2006. U.S. equity returned 3.52 percent for the month, underperforming the benchmark by 4 bps and by 1 bp for the year. International equity returned 7.07 percent, outperforming the benchmark by 10 bps for the month, while underperforming by 18 bps for the year. Fixed income returned 10 bps underperforming the Lehman Universal by 4 bps, while outperforming by 55 bps for the year. Private equity returned 1.1 percent for the month. Draws were at $178 million: $84 million by KKR and $94 million by the LP portfolio. Distributions back were at $195 million: $31 million from KKR and $164 million from the LP portfolio. No investments were closed in January. Real estate returned 0.7 percent for the month. Draws were at $155 million and distributions back were $89 million. The 2004 monthly average draws were $71 million, and distributions were $108 million.

ASSISTANT ATTORNEY GENERAL'S REPORT

Mr. Silver said that there was nothing to report.

OTHER ITEMS

Chair McElligott thanked Vice Chair Brookman for her service on the Board and to the beneficiaries.

There was no further business to come before the Board. The meeting adjourned at 11:45 a.m.

Pat McElligott
Chair

ATTEST

Joseph A. Dear
Executive Director