WASHINGTON STATE INVESTMENT BOARD
Board Meeting Minutes
April 20, 2006

The Washington State Investment Board met in open public session at 9:32 a.m. in the boardroom at 2100 Evergreen Park Drive SW, Olympia, Washington.

Present:	Pat McElligott, Chair Glenn Gorton, Vice Chair Senator Lisa Brown Mike Colleran Charlie Kaminski John Magnuson George Masten Sandy Matheson Bob Nakahara Dave Scott Jeff Seely Representative Helen Sommers Gary Weeks
Absent:	David Nierenberg
Also Present:	Joe Dear, Executive Director Gary Bruebaker, Chief Investment Officer Diana Will, Senior Investment Officer – Asset Allocation Kristi Haines, Executive Assistant Paul Silver, Assistant Attorney General

[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.

ADOPTION OF MINUTES – MARCH 16, 2006

Mr. Weeks moved to adopt the March 16, 2006, Board meeting minutes. Vice Chair Gorton seconded and the motion carried unanimously.

PUBLIC COMMENT

There was no public comment.

CAPITAL MARKETS ASSUMPTIONS

Ms. Will introduced staff's recommendation for 2006 capital market assumptions. While no one can predict the future, capital market assumptions quantify the expected average annual return and risk level of each asset class over the long-term. The proposed capital market assumptions are staff's best assumption of what markets will do over the next 10-20 years and how they will relate to each other.

[Representative Sommers was in attendance at 9:34 a.m.]

Ms. Will said that the proposal has minor changes from last year's assumptions. These include an increase in the private equity return expectations from 11-1/2 to 12-1/2 percent based on the public markets spread. The public equity spread would reflect the policy expectation as to how much it will exceed the S&P 500 return. A reduction in the real estate risk level is proposed because the core portfolio will be held to produce income, which is less volatile. A reduction to the risk level for long duration bonds is also proposed based on the current market.

Ms. Will highlighted new sections of the white paper, which include a definition of risk. She described the difference between a geometric versus arithmetic return calculation. A geometric return will always be equal to or lower than an arithmetic return. She also reviewed the results the 2006 capital market assumptions would have on the Commingled Trust Fund (CTF).

[Senator Brown was in attendance at 9:39 a.m.]

Mr. Kaminski asked about the correlation between fixed income and long bonds. Ms. Will said she would look at the correlation over the 15- and 20-year periods and over the shorter term.

Ms. Will said that the expected returns were like the benchmark return, which does not have fees.

> **Vice Chair Gorton moved that the Board adopt the 2006 WSIB capital market return, risk, and correlation assumptions as stated in the Board packet material. Ms. Matheson seconded and the motion carried unanimously.**

ADMINISTRATIVE COMMITTEE REPORT

Pension Funding Stabilization Account Policy 2.15.600 Adoption

Mr. Dear explained that the WSIB was assigned to manage the Pension Funding Stabilization Account established by the Legislature to help pay the state's portion of unfunded liabilities for plan one retirement systems. The WSIB expects to receive $350 million in late May. Due to the nature of the funding, the funds cannot be invested in long-term investments. Hence, a policy is needed to address the fund's investment options. Due to the appropriation and transfer of the monies, the WSIB will invest the account in cash and cash-like instruments, which will ultimately be transferred to the CTF.

> **Mr. Colleran moved that the Board accept the Administrative Committee's recommendation to approve the Pension Funding Stabilization Account Policy 2.15.600. Mr. Masten seconded and the motion carried unanimously.**

PUBLIC MARKETS COMMITTEE REPORT

Mr. Scott reported that the Public Markets Committee met on April 4 to interview managers for the cash overlay program, review Capital International's emerging markets strategy and portfolio, discuss implementation of the portable alpha strategy, and consider contract extensions for the domestic equity index manager and Labor and Industries industrial insurance consultant. Although a quorum of the Committee was present for the first agenda item only, Mr. Scott said that the consensus of members present was to forward the remaining agenda items to the Board for consideration.

Cash Overlay Program Management Selection

Mr. Scott reported that the Committee interviewed Frank Russell Securities and State Street Global Advisors for the cash overlay program. The object of a cash overlay program is to add small incremental return to the portfolio of approximately 2 to 5 basis points (bps) on a yearly basis over the long run by eliminating cash drag.

> **Mr. Scott moved that the Board accept the Public Markets Committee recommendation to select Frank Russell Securities, Inc. as the apparently successful offeror for the Cash Overlay Program Management mandate, subject to continued due diligence and successful negotiation of terms and conditions. Mr. Weeks seconded and the motion carried unanimously.**

Capital International Strategy and Portfolio Review

Mr. Scott reported that the Committee reviewed Capital International's investment management strategy and the Emerging Markets Growth Fund portfolio. Capital has outstanding long-term performance, outperforming by 309 bps and 299 bps, respectively, for the 10- and 15-year periods. Staff and the Committee have been closely monitoring Capital's short term underperformance and believe that this is an optimal time to invest additional assets in Capital's emerging markets portfolio.

> **Mr. Scott moved that the Board approve investing additional assets in Capital International's Emerging Markets Growth Fund. Mr. Masten seconded and the motion carried unanimously.**

Portable Alpha Related Index Implementation

Mr. Scott reported that a Barclays Global Investors (BGI) representative reviewed the portable alpha asset trust structure, where the WSIB would contribute shares of the U.S. index fund to the asset trust vehicle in return for Preference Shares, giving the WSIB the Russell 3000 return plus a premium of 15 bps to compensate for a 3-year lock-up on the assets and any securities lending income that would have been earned. This strategy will provide additional incremental returns to the portfolio.

> **Mr. Scott moved that the Board approve adopting the portable alpha concept as a Preference Shareholder with a total investment of up to 25 percent of the Commingled Trust Fund U.S. equity indexed assets (at time of purchase), subject to continued due diligence and successful negotiation of terms and conditions. Ms. Matheson seconded the motion.**

Mr. Masten reported that the Public Markets Committee had considerable discussion on the proposed concept. He said he plans to vote against it. Mr. Masten said if the Dow Jones Wilshire 5000 continues to outperform the Russell 3000, this proposition would not make money.

Mr. Bruebaker said that he is a firm believer in mean reversion as evidenced in the decision to invest additional assets in Capital International's Emerging Markets Growth Fund. Mr. Bruebaker reported that a research project is scheduled to perform an analysis of the underlying reasons why the Dow Jones Wilshire 5000 is outperforming the Russell 3000. Mr. Bruebaker reassured the Board that staff would not make the move without further analysis, and noted that the motion is subject to continued due diligence.

Mr. Colleran said that he would be interested in a return of the motion after the study, rather than in advance. A discussion ensued regarding the process staff would go through if the Board approved the motion at the April Board meeting. Mr. Masten said he would be more comfortable if it was clear that no action would be taken until study results were brought back to the Board.

> **Mr. Masten moved that the Board table any action on the Portable Alpha Related Index Implementation. Mr. Colleran seconded the motion. The motion passed, with Mr. Scott and Mr. Weeks voting no.**

Chair McElligott directed staff to report back to the Board at its September 2006 meeting.

Contract Extensions

The contracts with BGI for domestic equity index management and Conning for the Labor and Industries industrial insurance consultant are up for the final one-year extensions. Both vendors are performing satisfactorily, and both contracts have clauses that allow the Board to remove them without cause upon 5-days notice.

> **Mr. Scott moved that the Board approve authorizing the executive director to extend the contract with Barclays Global Investors, Contract Number 02-005, for one year, through December 31, 2007, as provided in the terms of the contract; and to extend the contract with Conning Asset Management, Contract Number 02-006, for one year, through December 31, 2007, as provided in the terms of the contract. Mr. Weeks seconded the motion.**

Chair McElligott noted that these were the final extensions for both contracts.

> **The above motion carried unanimously.**

PRIVATE MARKETS COMMITTEE REPORT

Mr. Masten reported that the Private Markets Committee met on April 6, 2006, to discuss four investment recommendations.

Real Estate

Morgan Stanley Real Estate Special Situations Fund III, L.P.

Mr. Masten moved that the Board accept the Private Markets Committee recommendation to approve an investment of up to $150 million, plus fees and expenses, in Morgan Stanley Real Estate Special Situations Fund III, L.P., subject to continuing due diligence and final negotiation of terms and conditions. Vice Chair Gorton seconded the motion.

Mr. Masten noted that the WSIB has had a number of real estate investments with this group, which have provided substantial returns for fund beneficiaries. Mr. Masten said that the recommendation is based, in part, on the following: (1) The management team is deep and experienced, and is substantially the same team that leads the Morgan Stanley Real Estate Funds. Many key members of the investment team are well known to WSIB staff. (2) MSSS III has a strategy of investing in non-control positions in real estate operating companies (REOCs) with a global mandate. (3) An investment of $150 million entitles the WSIB to Major Investor status. This status provides lower fees, improved governance terms, and preferential co-investment terms. (4) MSSS III's strategy will expose the WSIB to a number of local management teams in a variety of markets. Staff will be monitoring these companies and if any of these groups show outstanding investment skills and are of sufficient scale, they could graduate in the future from MSSS III to a more direct investment relationship with the WSIB. Mr. Masten emphasized that this group has produced substantial returns, he supports the recommendation, and believes it is a great investment opportunity.

Mr. Colleran reported that Treasurer Murphy had supported the investment recommendation at the Private Markets Committee meeting, but had serious reservations about the unique fee structure of the investment. Mr. Bruebaker responded to Mr. Colleran's questions and Mr. Dear noted that the WSIB does not currently have another investment with a similar fee structure, but this investment is similar to others in the market. Mr. Magnuson said that this is a unique opportunity as an opened ended fund with a firm that has a great track record and $700 million already invested. He further noted that another unique feature is the opportunity it brings for co-investments, especially in emerging markets. Mr. Magnuson said the investment shows terrific potential. Mr. Bruebaker responded to questions from Ms. Matheson about exit strategies and the composition of the investment. He added that the WSIB has large investor privileges with the investment that others do not.

The above motion carried unanimously.

Private Equity
<u>The Fourth Cinven Fund</u>

Mr. Masten moved that the Board accept the Private Markets Committee recommendation to approve an investment of up to €125 million, plus fees and expenses, in The Fourth Cinven Fund, L.P., subject to continued due diligence and final negotiation of terms and conditions. Vice Chair Gorton seconded the motion.

Mr. Masten reported that the Committee recommends an investment of up to €125 million in The Fourth Cinven Fund, L.P., based, in part, on the following: (1) The fund has a deep, cohesive, and experienced team of 45 investment professionals, including 19 partners with an average tenure of 11 years with the firm. (2) The firm has a solid track record over a long time period with substantial realizations. Since 1996, Cinven has drawn down €6.9 billion in three funds, and has produced €6.6 billion in distributions and €3.0 billion in net residual value, for a combined net IRR of 14.1 percent and a net value multiple of 1.4x. (3) The firm has a pan-European presence and experience, with three offices strategically located in London, Paris, and Frankfurt. (4) Cinven has a successful, sector-focused investment strategy, targeting large buyout transactions in six key sectors. (5) This investment represents an opportunity to expand a successful relationship with a high-quality, existing general partner.

The above motion carried with Mr. Colleran voting no.

Mr. Colleran explained that Treasurer Murphy voted no due to a concern about the delay of financial data provided to the Private Markets Committee.

New Enterprise Associates 12, L.P.

Mr. Masten moved that the Board accept the Private Markets Committee recommendation to approve an investment of up to $100 million, plus fees and expenses, in New Enterprise Associates 12, L.P., subject to continued due diligence and final negotiation of terms and conditions. Vice Chair Gorton seconded the motion.

Mr. Masten reported that the Committee recommends an investment of up to $100 million in New Enterprise Associates 12, L.P., based, in part, on the following: (1) The firm has a deep, experienced team of 27 full-time investment professionals and 11 part-time venture partners, with an excellent reputation and network in the entrepreneurial community. (2) The firm has a strong overall, track record. Since 1981, NEA has drawn down $5.0 billion in ten funds and one annex fund, which have produced $5.5 billion in distributions and $2.6 billion in net residual value, for a combined net IRR of 19.0 percent and a net value multiple of 1.6x. (3) The firm has a leading venture capital franchise. NEA is one of the largest and most active investors in venture capital and is widely regarded as being in the top tier of venture firms, which improves access to syndicate deals with other top-tier venture firms. (4) The fund will continue NEA's successful strategy of seed through late stage venture investing in the information technology and healthcare sectors. (5) This is a rare opportunity to expand a successful relationship with a top-tier venture capital partner.

The above motion carried unanimously.

HIPEP V Asia Pacific and Rest of World Partnership Fund, L.P.

Mr. Masten moved that the Board accept the Private Markets Committee recommendation to approve an investment of up to $75 million, plus fees and expenses, in HIPEP V – Asia Pacific and Rest of World Partnership Fund, L.P., subject to continued due diligence and final negotiation of terms and conditions. Vice Chair Gorton seconded the motion.

Mr. Masten reported that the Committee recommends an investment of up to $75 million in HIPEP V – Asia Pacific and Rest of World Partnership Fund, L.P., based, in part, on the following: (1) The management team is one of the most cohesive and experienced in the industry. The two founders have been investing in private equity partnerships since the late 1970s. HarbourVest is a deep organization with 57 investment professionals. The 15 managing directors have worked together an average of 17 years. (2) Over the past 10 years, HarbourVest has developed extensive on-the-ground knowledge of the Asian market and the general partners in the region. (3) HarbourVest has produced strong Asian buyout performance. Asian buyouts have become an increasing percentage of the HIPEP funds, and will be the focus of this fund. (4) Many of the underlying funds in which HarbourVest invests will be small regional and country funds that would be difficult for the WSIB to access directly. The fund-of-funds strategy is an excellent way for WSIB to gain exposure to the Asian and other emerging markets with the use of limited staff resources. (5) The WSIB receives ancillary benefits from the HarbourVest relationship, including market intelligence and due diligence information. (6) This is an opportunity to expand an existing relationship with a long-term, high quality partner.

Mr. Masten noted that there was also substantial discussion on this recommendation at the Committee meeting. He expressed that the investment would provide opportunity to develop relationships through HarbourVest with Asian partners that would be difficult for the WSIB to access directly at this time.

Mr. Colleran shared that Treasurer Murphy had voted no on the investment at the Committee meeting due to what he felt was an undistinguished return compared to the risks. He shared that the Treasurer felt other WSIB partners will be providing additional exposure to Asia. Mr. Seely said that he shares the concerns about the returns.

The above motion carried with Mr. Colleran voting no.

STAFF'S REPORT

Executive Director's Report

Mr. Dear provided his monthly report for April on Board governance, staff, investments, budget, operations, public affairs, legislation, and open procurement activities. He noted that a report on meetings held with Washington State private equity firms was distributed to members.

Mr. Dear reported that proxy season is underway. He referred to articles copied for the Board's information on various proxy issues. Representative Sommers noted that the proposed Securities and Exchange Commission (SEC) rule on executive pay has been outstanding for some time. Mr. Dear said that staff would find out when the SEC is expected to act on it.

Monthly Investment Report

Mr. Bruebaker reported that the U.S. equity portfolio returned 1.8 percent in March, underperforming the performance of the benchmark by 3 bps for the month, and underperforming by 7 bps for the year ended March 31, 2006. The international equity portfolio returned 2.9 percent for the month, outperforming the benchmark by 1 bp, while underperforming by 34 bps for the year. The CTF fixed income investment portfolio lost 94 bps for the month, underperforming the performance of the Lehman Universal by 5 bps. Private

Equity returned 4.3 percent for the month. Draws were $80 million, with $1 million from KKR with the remaining balance coming from the LP portfolio. Average monthly draws for 2005 were $186 million. Distributions were $146 million, with $5 million from KKR and the balance coming from the LP portfolio. Charterhouse Capital Partners VIII, Fortress Investment Fund IV, Blackstone Capital Partners V, TPG Partners V, and Madison Dearborn Capital Partners V closed in March. Real Estate returned 6.3 percent for the month.

ASSISTANT ATTORNEY GENERAL'S REPORT
Mr. Silver said that he had nothing to report.

OTHER ITEMS
Mr. Nakahara asked when the results of the McKinsey & Company study would be shared. Mr. Dear said that preliminary final recommendations are expected within two weeks. These are expected to be powerful recommendations for top level performance of any private equity investor. Mr. Dear noted that fundamental risk and governance issues are focus areas for the Board retreat and McKinsey will be there. McKinsey will introduce their recommendations to members interviewed for the study.

There was no further business to come before the Board. The meeting adjourned at 10:43 a.m.

Pat McElligott
Chair

ATTEST

Joseph A. Dear
Executive Director