WASHINGTON STATE INVESTMENT BOARD
Board Meeting Minutes
May 18, 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 (via teleconference) Charlie Kaminski John Magnuson (via teleconference) George Masten Sandy Matheson Treasurer Mike Murphy Bob Nakahara David Nierenberg Dave Scott (via teleconference)
Absent:	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 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 – APRIL 20, 2006

Vice Chair Gorton moved to adopt the April 20, 2006, Board minutes. Ms. Matheson seconded and the motion carried unanimously.

PRIVATE MARKETS COMMITTEE REPORT

Mr. Masten reported that the Private Markets Committee met on May 4, 2006, and discussed two investment recommendations.

Private Equity Investment Recommendation – GTCR Fund IX, L.P.

> **Mr. Masten moved that the Board accept the Private Markets Committee's recommendation to approve an investment of up to $200 million, plus fees and expenses, in GTCR Fund IX, L.P., subject to continuing due diligence and final negotiation of terms and conditions. Treasurer Murphy seconded the motion.**

Mr. Masten reported that GTCR Fund IX, L P., a private equity fund with a target size of $2.25 billion and a cap of $2.75 billion, will focus on U.S. based companies in five sectors: consumer products and services, healthcare, outsourced business services, technology, and transaction processing. The WSIB has invested in three previous GTCR funds: $50 million in GTCR Capital Partners in 1999, $125 million in GTCR Fund VII in 2000, and $125 million in GTCR Fund VIII in 2003. He said that the Committee's recommendation is based, in part, on the following: (1) GTCR has a deep and experienced management team with strong industry expertise. The six senior principals have an average of 16 years of private equity experience and have worked together at GTCR for more than ten years. The team has extensive knowledge, relationships, and networks in the five sectors in which the firm focuses. (2) The firm has a proven, differentiated strategy. GTCR's strategy of proactive recruitment and partnering with top industry executives to execute acquisition programs has proven successful through multiple investment cycles. (3) The firm has strong investment performance over a long time period with substantial realizations. The firm has generated an aggregate net IRR of 26.6 percent and a net multiple of 2.0x on $4.7 billion of drawn capital since 1980, including $6.3 billion in distributions. (4) The investment is an excellent portfolio fit. GTCR's strategy provides diversification within the portfolio, having minimal overlap with the strategies of other WSIB partners. (5) This is an opportunity to expand a successful relationship with a high-quality partner.

> **The above motion carried unanimously.**

Pathway Capital Management – Contract Extension and Allocation Increase
Mr. Masten reported that the Committee recommends a one-year extension of the Pathway Capital Management contract; an amendment to the investment guidelines to increase the amount that Pathway can commit to a partnership from $30 million to $50 million and to eliminate the restriction on maximum fund size of $750 million; and an additional allocation of up to $300 million to be invested under the terms and conditions of the contract.

Mr. Masten said the recommendation is based, in part, on the following: (1) Pathway has an experienced, stable management team. The team consists of 12 partners and 35 investment professionals. The founders have worked together over 20 years. Since inception of the firm, Pathway has experienced no turnover of the senior professionals or management. (2) Pathway has demonstrated the ability to access quality partnerships. The senior members of the firm have established and maintained long-term relationships with high quality general partners, thereby providing access to Pathway clients. Pathway has demonstrated the ability to obtain meaningful commitments for the WSIB to high quality partnerships. (3) The firm has strong long-term performance. Since the 1996 inception, the Pathway portfolio has produced a net IRR of

19.2 percent. (4) The firm has a superior proprietary database system and excellent reporting. Pathway's system was developed in-house over a number of years to maintain extensive knowledge of the industry, provide excellent customer service, and produce comprehensive reports. (5) The additional allocation will provide for meaningful exposure to venture capital, a sub-class currently at the low end of its target range within the private equity portfolio. (6) The recommendation represents an opportunity to expand a successful long-term relationship.

Treasurer Murphy advised the Board that he had voted to extend the Pathway contract at the Committee meeting, but did so with extraordinary reluctance. He noted that staff had suggested a five-year extension. Treasurer Murphy said that, with the exception of 1997, Pathway's numbers are dismal. Treasurer Murphy chose to give Pathway one more year to show better numbers. Chair McElligott commented that it is a tough market, but he shares similar concerns with the Treasurer.

Mr. Nierenberg said that he spoke in favor of the extension at the Committee meeting, and appreciates the Treasurer granting an additional year. He suggested that a strategic planning discussion on the role of venture capital should occur. He noted that it may also be worthwhile to look at other firms providing similar services.

> **Mr. Masten moved that the Board accept the Private Markets Committee's recommendation to approve a one-year extension of the Pathway Capital Management contract; an amendment to the investment guidelines to increase the amount that Pathway can commit to a partnership from $30 million to $50 million and eliminate the restriction on a maximum fund size of $750 million; and grant an additional allocation of up to $300 million to be invested under the terms and conditions of the contract. Mr. Gorton seconded and the motion carried unanimously.**

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 March 31, 2006, were provided to members.

Mr. Bruebaker said he would focus on capital markets and investment performance in active strategies. He identified corrections on page 1 of the CTF report, which was redistributed at the meeting.

Mr. Bruebaker noted the quarterly returns of the Dow Jones Wilshire 5000 since 2000. He reported that the S&P 500 registered its best quarter since 1999. During the quarter, value outperformed growth by 250 basis points (bps), and the ACWI ex-U.S. outperformed U.S. markets by 440 bps. For the one-year, growth outperformed value by 20 bps and the ACWI ex-U.S. outperformed U.S. markets by 1,340 bps. In the first quarter, small cap, as measured by the Russell 2000, earned 13.9 percent outperforming large cap, as measured by the Russell 1000, by almost 10 percent, returning 4.9 percent. Small cap also outperformed large cap for the one-, three-, five-, and ten-year periods. The consumer price index was higher than expected in April, and stock and bond markets were off. Mr. Bruebaker noted that the Fed has raised their rates every time they have met since June 30, 2004, and federal funds futures indicate a 50/50 chance for an increase in June 2006. He made note of the impact this has on the yield curve.

Mr. Bruebaker reported that performance has been outstanding and staff continues to track its Implementation Value Added (IVA) benchmark, which is tougher than both TUCS benchmarks. He explained that IVA looks at the benchmark established for each asset class and its target allocation, which helps to analyze performance and how managers are doing compared to the benchmark.

Mr. Nierenberg commented on use of the TUCS benchmarks and said it would be worthwhile to know how the WSIB is doing relative to peer groups. Staff offered to provide whatever detail the Board requests, but explained that WSIB's overweighting in private markets creates issues with peer comparisons. Chair McElligott said that the suggestion could be discussed further at the July retreat.

Mr. Bruebaker reported the CTF was at $53.6 billion. International equity outperformed for the quarter, but underperformed in other periods. It was hurt by underweighting in emerging markets. Mr. Bruebaker reviewed domestic and international developed and emerging markets manager performance. For the quarter, fixed income was at $12.3 billion, underperforming by 9 bps. It was somewhat aided by short duration and TIPS, but everything else worked against it. The longer term performance continues to be outstanding.

Private Equity

Mr. Ruggels presented the private equity funds quarterly report for the period ended December 31, 2005. He noted that this is the last performance report prepared by Pacific Corporate Group, and announced that Capital Dynamics would prepare and present the next quarter report in September.

Mr. Ruggels reviewed the commitment activity for the quarter with $530.6 million in commitments authorized and $280.6 million in commitments closed. Quarterly contributions were $867 million, distributions were $858 million, and net appreciation was $742 million, which resulted in a portfolio market value of $8.5 billion as of December 31, 2005. He reported that the unfunded commitment balance at year end was $4.8 billion. The IRR since inception was 14.8 percent, with 17.1 percent from the KKR portfolio and 11.8 percent from the LP portfolio.

Mr. Ruggels reviewed the 2005 draws, distributions, and appreciation/depreciation activity by each quarter and commented on the strong investment and distribution pace of the portfolio. He highlighted the outstanding one-year performance of 32.2 percent. He remarked that returns for all time periods up through the 10-year period have exceeded the S&P 500 + 500 bps benchmark.

Mr. Ruggels described the portfolio's sub-sector performance, noting the value of diversification and private equity's cyclical nature. While venture capital performance has lagged other sub-classes for the three-, and five-year periods, venture capital was the best performing sub-class for the ten year period. Venture capital currently represents 12 percent of the private equity portfolio on a market value basis, below the staff-established allocation target range of 15-25 percent. All other allocations are within the established ranges. He said that while funds that invest primarily in international markets represent 20 percent of the portfolio, at the portfolio company level, the allocation to international is about 31 percent. In response to Treasurer Murphy's question, Mr. Ruggels said that the KKR European Fund is included in the international category and the Millennium Fund is categorized under corporate finance. He explained some of the funds categorized as domestic have international components, and that some categorized as international have domestic components, though this is less common.

Real Estate

Mr. Draper reported on the performance of the real estate portfolio as of December 31, 2005. He said that the portfolio was at $5 billion, which is just below 10 percent of the CTF. There was $5.8 billion in unfunded commitments at year end, as WSIB's partners are exercising restraint in an expensive market. The weight of capital on the asset class has created unprecedented demand in the market place, specifically in the U.S. A rise in interest rates may moderate it some, but pricing is expected to remain under upward pressure. Mr. Draper said that more attractive opportunities are outside of the U.S. He noted that national statistics tend to hide both strong and challenging markets. No major pricing correction is anticipated in the near term for the type of real estate in which WSIB invests.

Mr. Draper reviewed the WSIB net returns, which takes out fees and expenses, against the NCREIF gross returns. The WSIB portfolio outperformed NCREIF in every period; this is appropriate given that WSIB takes more risk than represented in the index. The five- to ten-year returns compared against the NCREIF + 100 bps benchmark show a premium of approximately 300 bps of outperformance. Mr. Draper reported that most of the outperformance is due to REOC holdings and foreign investments, and specifically in growth and distressed markets. He pointed out that 55 percent of the portfolio is with the four largest partners: PEC, Hometown America, Lone Star and Morgan Stanley, all continuing to provide outstanding returns.

He described the portfolio diversification by property type and explained the composition of the "Other" property type. Self-storage was added to the Other category this quarter, and the portfolio has increased its land presence, to add value through development. Compared to NCREIF, WSIB's portfolio is underweight in retail, and staff would like to do more in the sector. It is underweight in office by design, which is generally more volatile and costly to operate over the long term.

Compared to NCREIF, WSIB's portfolio is overweight in growth markets, particularly in the West and South, by design. It is underweight in the East, also by design. Globally, staff feels good about Asia, which is overweight at this time and is benefiting from distressed investments made earlier in Japan which are now being realized. Treasurer Murphy asked for comment on Lone Star's activity in Korea, any affect on returns that could occur, and what percentage of the portfolio is invested within Korea. Mr. Draper stipulated that he would be limited to discuss the situation in an open meeting. He said that there could be an effect on the return if it turns out taxes are owed, but Lone Star's returns are extraordinary in Korea in any event. He agreed to look into the exact percentage in each fund that Lone Star holds in Korea, but knows the combined exposure for WSIB with Lone Star is Korea is within single digits.

Mr. Draper summarized that real estate is currently a pricey market with lots of investors trying to get in. The WSIB partners remain prudent, making good and wise investments. The portfolio is experiencing unprecedented returns.

[The Board recessed at 10:46 a.m. and reconvened in open public session at 11:00 a.m.]

BOARD ADOPTED POLICY REVIEW

Mr. Dear introduced staff's proposal for a review of Board-adopted policies. He commented on the importance of board governance and the need to stay focused on what we are doing as an institutional investor. Mr. Dear described the governance activity undertaken by the Board three years ago, which resulted in new charters and policy revisions. At that time, the Board agreed to perform a review of charters and policies every three years. Mr. Dear noted that some charters and policies have been reviewed since 2003 out of necessity, including minor adjustments made following last year's compliance review by Cortex Applied Research. Mr. Dear announced that Beth Vandehey will present findings of a compliance review she recently conducted at the May 31 Audit Committee meeting.

Mr. Dear said that staff is currently reviewing all Board-adopted charters and policies and plans to bring suggested revisions to the June Board meeting. He asked members to identify by May 26 any charter or policy they want included in this process. Staff does not expect that members will read every charter and policy but, rather, focus on roles, policy elements, etc. Since the Board ultimately approves charters and policies, staff wants to ensure that it includes issues, concerns, and any documents of particular interest. Mr. Dear suggested that the Board could also address policy issues at the July retreat. Mr. Nierenberg stressed the importance of this activity.

In response to Treasurer Murphy's inquiry on the status of the outside employment policy draft, Mr. Dear said that new policy issues would be handled separately from the policy review.

STAFF'S REPORT

Executive Director's Report

Mr. Dear provided his monthly report for May on Board governance, staff, investments, budget, operations, public affairs, and open procurement activities.

Mr. Dear presented staff's suggested agenda for the July retreat, and invited input from Board members. At Treasurer Murphy's request, Mr. Dear provided details on invited speakers. Chair McElligott, Treasurer Murphy, and Mr. Kaminski expressed a desire to have an independent meeting facilitator and identified a specific corporate governance program where resources might be available. Mr. Kaminski proposed that the Audit Committee further discuss a governance framework for the retreat.

Mr. Nierenberg expressed his support for two of staff's proposed speakers. He suggested that, time permitting, the Board discuss expanding active management of domestic equities. A discussion ensued regarding the Board's historical decision-making process regarding use of passive indexes and the resulting performance, and whether there was sufficient time available at the retreat for this discussion.

Chair McElligott asked staff to have an updated July retreat agenda available at the June Board meeting after noted discussions have occurred and issues are resolved. Mr. Kaminski agreed to contact his suggested facilitator.

Treasurer Murphy shared his opinion on the private equity best practices study scheduled for discussion at the July retreat.

Monthly Investment Report

Mr. Bruebaker reported that the U.S. equity portfolio returned 1.1 percent in April, underperforming the performance of the benchmark by 2 bps for the month, while outperforming by 7 bps for the year ended April 30, 2006. The international equity portfolio returned 5 percent for the month, underperforming the benchmark by 21 bps, while outperforming by 196 bps for the year ended April 30, 2006. The CTF fixed income investment portfolio lost 10 bps for the month, outperforming the performance of the Lehman Universal by 6 bps. The one-year performance outperformed the Universal by 12 bps. Private Equity returned 1.1 percent for the month. Draws from the LP portfolio were $168 million; no draws were made in the KKR portfolio. Average monthly draws for 2005 were $186 million. Distributions back to the WSIB were $203 million, with $70 million coming from KKR and $133 million from the LP portfolio. Average monthly distributions for 2005 were $223 million. The Cinven Fourth Fund (€125 million) and New Enterprise Associates 12 ($50 million) closed in April. Real Estate returned 1.0 percent for the month. Draws were $170 million. Average monthly draws for 2005 were $71 million, which is double the average. Distributions back to WSIB were $65 million. Average monthly distributions in 2005 were $108 million.

Treasurer Murphy reported that the GET Fund currently amounts to $704 million, with 66,000 accounts established for future tuition liability. He said that he is privileged to serve on the GET Committee and urged staff to keep up the good work.

ASSISTANT ATTORNEY GENERAL'S REPORT

Mr. Silver had nothing to report

OTHER ITEMS

There was no further business to come before the Board. The meeting adjourned at 11:48 a.m.

Pat McElligott
Chair

ATTEST

Joseph A. Dear

Joseph A. Dear
Executive Director