WASHINGTON STATE INVESTMENT BOARD
Board Meeting Minutes
June 15, 2006

The Washington State Investment Board met in open public session at 9:33 a.m. in the boardroom at 2100 Evergreen Park Drive SW, Olympia, Washington.

Present:	Pat McElligott, Chair Glenn Gorton, Vice Chair Senator Lisa Brown Charlie Kaminski George Masten Sandy Matheson Treasurer Mike Murphy Bob Nakahara David Nierenberg (via teleconference) Dave Scott Gary Weeks
Absent:	John Magnuson Jeff Seely Representative Helen Sommers
Also Present:	Joe Dear, Executive Director Gary Bruebaker, Chief Investment Officer Theresa Whitmarsh, Deputy Director for Operations Kristi Haines, Executive Assistant Paul Silver, Assistant Attorney General Tom Iannucci, Cortex Applied Research

[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 took roll call.

ADOPTION OF MINUTES – MAY 18, 2006

Vice Chair Gorton moved that the Board adopt the May 18, 2006, meeting minutes. Treasurer Murphy seconded and the motion carried unanimously.

PUBLIC COMMENT

There was no public comment.

ADMINISTRATIVE COMMITTEE REPORT

2007-2009 Biennial Budget

Chair McElligott reported that the Administrative Committee met just prior to the Board meeting and discussed the proposed budget.

> **Chair McElligott moved that the Board accept the Administrative Committee's recommendation to approve the proposed budget for the 2007-2009 biennium for submission to the Office of Financial Management. Mr. Scott seconded the motion.**

Mr. Dear said that the Administrative Committee reviewed the budget in detail. It represents a 14.7 percent increase, mainly due to maintenance level requests. He explained that the agency currently has 72 FTEs authorized but funding for only 67. Restoring staffing needs represents the largest piece of the budget increase, which also includes travel; information technology equipment; and merit system increments, contractual obligations, and lease increase maintenance level requests. Enhancements proposed as performance level requests include one FTE for the risk management program, one FTE for internal audit, and increased Attorney General services. Mr. Dear reported that the proposed appropriated budget represents .026 percent of total assets under WSIB management. He described the process for approving the budget, which takes effect beginning July 1, 2007, through June 30, 2009.

> **The above motion carried unanimously.**

Communications Policy 2.00.175 Adoption
Outside Employment Policy 2.00.101 Adoption

Chair McElligott announced that he deferred the Communications and Outside Employment Policy agenda items 3-b and 3-c to the July Board meeting.

Agency Request Legislation

Mr. Dear reported that neither staff nor the Administrative Committee had agency request legislation recommendations for 2007. There were no recommendations from Board members. Mr. Dear said that staff would respond to any legislation proposed during the 2007 session that could potentially impact the agency.

Assistant Attorney General's Report

Mr. Silver reported on the Enron litigation, including settlements to date and recent judicial actions involving certification of the litigation as a class action. He reported on the recent indictment of the Milberg Weiss law firm on alleged referral fees violations. The Lerach Coughlin firm used by the WSIB in the Enron litigation broke off from Milberg Weiss in 2004. It is not clear from newspaper reports whether Mr. Lerach might be involved in any related investigation.

Human Resources Policy 2.00.000 Adoption

Chair McElligott announced that he deferred the Human Resources Policy agenda item 3-f to the July Board meeting.

[Mr. Weeks arrived at 9:40 a.m.]

EDUCATION SESSION – INVESTMENT BELIEFS

Mr. Bruebaker introduced the investment beliefs education session. The purpose of the session is to pique the Board's curiosity and interest in the subject, not to discuss nor document the Board beliefs. He said that establishing and documenting a clear set of investment beliefs is critical for the organization to move to the next level. The Board's July meeting will include governance and risk topics and the results of the McKinsey study, which touches on investment beliefs relative to private equity. Staff plans to have a series of discussions and presentations on investment beliefs over the next six to 12 months to help the Board develop investment beliefs for adoption. Mr. Bruebaker said that the WSIB's goal is not to compare against peer groups in their entirety but, rather, look at individual (asset class) areas to determine who is the best at each, what makes them the best, and how the WSIB can leverage that information to improve its processes. Mr. Bruebaker introduced Mr. Iannucci of Cortex Applied Research.

Mr. Iannucci said that establishing investment beliefs is an emerging trend among investment managers, pension plans, and endowment funds. He defined investment beliefs as fundamental assumptions or principles upon which programs and policies are premised and which explain why assets are managed in a particular way. He said that investment beliefs tend to develop slowly over time and facilitate discussion on fund management to ensure consistency and discipline.
Mr. Iannucci introduced Cortex's suggestions for developing investment beliefs and described why they are important. He provided examples of the impact that different sets of investment beliefs have on asset allocation, portfolio structure, performance measurement, and governance over time, and described some of the challenges with establishing investment beliefs. Mr. Iannucci reviewed staff's discussion of investment beliefs.

The Board discussed alignment of the WSIB's investment beliefs with managers it hires, the various levels of investment beliefs, and the effect changing Board membership could have on investment beliefs over time.

Mr. Iannucci concluded his presentation, stating that investment beliefs are the cornerstone of a successful investment organization.

[The Board recessed at 10:37 a.m. and reconvened at 10:47 a.m.]

PRIVATE MARKETS COMMITTEE REPORT

Mr. Masten reported that the Private Markets Committee met on June 1, 2006, and discussed five investment recommendations as well as a contract extension.

First Reserve Fund XI, L.P.

> **Mr. Masten moved that the Board accept the Private Markets Committee's recommendation to approve an investment of up to $300 million, plus fees and expenses, in First Reserve Fund XI, L.P., subject to continued due diligence and final negotiation of terms and conditions. Vice Chair Gorton seconded the motion.**

Mr. Masten said that the Committee's recommendation is based, in part, on the following: (1) the strong, experienced investment team. The firm's senior management team has a wealth of experience in the energy industry. Turnover above the associate/analyst level has been minimal, with most departures due to retirement. First Reserve Corporation (FRC) has grown responsibly over the past several years, and the investment team now numbers 27 investment professionals. (2) The strong investment performance. Since 1992, FRC has drawn down $3.6 billion for over 100 transactions, which have produced $4.3 billion in distributions and $3.1 billion in net residual value, for a net IRR of 27 percent, and a net value multiple of 2.0x. (3) Continuation of the firm's proven, focused strategy. For 23 years, FRC has focused solely on the energy industry and has developed a leading franchise, unmatched industry networks, and a deep pool of top management talent to run its companies. (4) Strong industry fundamentals. Twenty years of industry underinvestment, relentless demand growth in Asia, peaking supplies, and higher energy prices are predictive of massive capital spending on energy projects and development in the coming years, which should benefit the energy service companies FRC specializes in. (5) This investment represents an opportunity to expand a successful relationship with a high quality, existing partner.

The above motion carried unanimously.

Avenue Asia Special Situations Fund IV, L.P.

Mr. Masten moved that the Board accept the Private Markets Committee's recommendation to approve an investment of up to $100 million, plus fees and expenses, in Avenue Asia Special Situations Fund IV, L.P., subject to continued due diligence and final negotiation of terms and conditions. Vice Chair Gorton seconded the motion.

Mr. Masten said that the Committee's recommendation is based, in part, on the following: (1) Experienced investment team. The team has been together since the inception of the Asian strategy in 1999. The three senior principals have 58 years of collective expertise and are considered pioneers in the distressed debt and Asian distressed debt markets. (2) Proven strategy. Fund IV will continue with the successful strategy of targeting special situations opportunities in the assets of companies that Avenue believes are undervalued due to restructuring, reorganization, or financial distress. (3) Solid investment track record. Since inception in 1999, through three funds, Avenue Asia has generated a net aggregate IRR of 21.6 percent on $1.03 billion of invested capital, including $527 million in realizations. (4) Excellent portfolio fit. The pan-Asian strategy would further geographically diversify the WSIB portfolio. The Asian distressed and non-performing loans focus is unique within the portfolio's international sub-class.

The above motion carried unanimously.

Permira IV, L.P.

Mr. Masten moved that the Board accept the Private Markets Committee's recommendation to approve an investment of up to €100 million, plus fees

and expenses, in Permira IV, L.P., subject to continued due diligence and final negotiation of terms and conditions. Treasurer Murphy seconded the motion.

Mr. Masten said that the Committee's recommendation is based, in part, on the following: (1) Deep and experienced team. The investment team is one of the deepest in Europe, consisting of 70 investment professionals, including 28 partners with an average tenure of 11 years with the firm. Fifteen of the 28 partners have been with Permira for a decade or more. (2) Strong historical performance. Since 1997, Permira has drawn down €5.9 billion in three pan-European funds, which have produced €5.1 billion in distributions and €4.0 billion in net residual value, for a net IRR of 33.0 percent and a net value multiple of 1.5x. Between 1985 and 1996, the firm raised and invested nine smaller country specific funds, which in aggregate generated a net IRR of 24.0 percent and a net multiple of 2.4x. (3) Strategically located offices in the leading European financial capitals, New York, and Tokyo provide a valuable local presence and personal networks, which aid in deal flow. Most investment professionals are fluent in two or more languages and represent many nationalities. (4) Permira will continue its disciplined and successful strategy employed in prior funds, focusing on large buyout transactions in four key business sectors. While many private equity firms have recently adopted an industry-focused staff structure, Permira has been organized into sector teams since 1997. (5) This investment represents an opportunity to add a top-tier, high-quality general partner to the WSIB portfolio.

The above motion carried unanimously.

GMS International, LLC

Mr. Masten moved that the Board accept the Private Markets Committee's recommendation to approve an investment of up to $750 million, plus fees and expenses, in GMS International, LLC, subject to ongoing due diligence and final negotiation of terms and conditions. Vice Chair Gorton seconded the motion.

Mr. Masten reported that GMS International, LLC, is a real estate operating company (REOC) specializing in retail property that is currently owned by Principal Enterprise Capital (PEC), a WSIB-funded investment vehicle. This proposal will fund GMS's existing strategy of acquiring and developing necessity retail properties in the U.S., and will also provide them with capital to pursue lower-risk, lower-return properties, as well as attractive opportunities outside the U.S. These latter two strategies are outside the mandate of PEC, and thus require moving the GMS relationship from PEC to a direct relationship with WSIB. He said that the Committee's recommendation is based, in part, on the following: (1) GMS is one of the most successful real estate investments made by WSIB. The company has produced a from-inception net IRR of 29.5 percent. (2) The GMS team has a strong history of acquiring and developing well-located properties and creating value through aggressive leasing, redevelopment, and strong property management. GMS' retail experience, presence in key growth markets, and strong operating platform positions the company for future success. (3) The management team is cohesive and possesses exceptional investment and management skills as evidenced by their track record. (4) GMS currently operates a strategic portfolio of 17 high-quality shopping centers located in the western U.S. A significant portion of the proposed commitment to GMS would be used to facilitate the transfer from PEC. These assets provide a long-term, high-quality, stable income stream to WSIB, the first priority of the real estate program. (5) GMS has a substantial pipeline of development and acquisition opportunities outside the U.S. in conjunction with existing WSIB partners, including in China and Mexico. This will afford GMS the opportunity to add value through its retail property investment and management skills while benefiting from the knowledge and expertise of local partners. (6) The WSIB will have excellent governance rights, including the ability to remove the Managing Member with or without cause at any time. (7) Bill Gerrity and the management team will contribute at least 1 percent of total commitments as co-investment. This dollar amount constitutes a significant commitment for a REOC transaction. (8) And finally, the WSIB is materially underweighted in retail property, which is our highest priority globally. This recommendation, through expansion of the western U.S. portfolio and opportunities in international markets, will contribute to improving the diversification of the WSIB's real estate portfolio.

The above motion carried unanimously.

Warburg Pincus Real Estate I, L.P.

Mr. Masten moved that the Board accept the Private Markets Committee's recommendation to approve an investment of up to $100 million, plus fees and expenses, in Warburg Pincus Real Estate I, L.P., subject to continuing due diligence and final negotiation of terms and conditions. Mr. Weeks seconded the motion.

Mr. Masten said that the Committee's recommendation is based, in part, on the following: (1) Warburg Pincus is a high-quality organization, and we believe that this team will continue the success of the firm's private equity business. (2) The Fund has a strategy of owning non-control positions in real estate operating companies around the globe. We believe that investing in or with high-quality local operating companies is a preferred method of investing in real estate. The target strategy for WPRE I in Asia, focused on the high growth markets of China and India, is particularly attractive. This fund will provide the WSIB with diversification through exposure to different property types in a variety of markets. (3) The WSIB real estate strategy has a strong focus on growth markets, both within the U.S. and globally. WPRE I's strategy will provide the WSIB with investments in markets where high levels of growth are expected. WPRE I will position the WSIB to take advantage of the considerable business and housing needs of emerging markets.

Treasurer Murphy reported that he voted no on the investment recommendation at the Committee meeting and would vote no again. He said that he feels the team is too thin, with only a few people covering very large geographical areas and he does not see how the investment can be managed properly in this situation. Mr. Weeks shared his concern with it being the first real estate fund for the team, and noted the average ratings given to its management, strategy, and governance. Mr. Masten reported that the team is part of the Warburg Pincus organization, which has always held real estate in their portfolios. Warburg Pincus decided to set-up this real estate fund as a separate entity. Mr. Masten and Mr. Bruebaker emphasized that the team has the backing of the larger organization. Ms. Matheson said she is in favor of the fund which has the infrastructure substance behind them. Treasurer Murphy said that he did not disagree with most of the comments, but noted that the fund is separately sourced from the private equity arena, which is a disconnection. Mr. Nierenberg said that he listened to the presentation at the Committee meeting and understands what the fund is doing. He noted Mr. Magnuson's expertise, who wrote in favor of the deal. Mr. Nierenberg said he supports the recommendation.

The above motion carried with Treasurer Murphy voting no.

INVESCO Private Capital Contract Extension for Limited Purposes

Mr. Masten moved that the Board accept the Private Markets Committee's recommendation to extend the INVESCO Private Equity contract for 1 year to provide transaction management and limited reporting services under the current contract at a fee of up to $55,000. Vice Chair Gorton seconded the motion.

Mr. Dear said that staff would move forward with the proposal if the Board approves it.

Mr. Masten reported that the contract with INVESCO is scheduled to end on June 30, 2006. INVESCO currently provides, among other tasks, transaction management, performance measurement, and reporting on 35 investments. In order to ensure that these services continue without interruption beyond June 30, the Private Markets Committee recommends extending the INVESCO contract 1 year as allowed under the contract terms, but only for transaction management and some aspects of portfolio monitoring, performance measurement, and reporting on the 35 investments. Mr. Dear emphasized that no new investments would be done with INVESCO as part of this extension.

The above motion carried unanimously.

AUDIT COMMITTEE REPORT

Treasurer Murphy reported that the Audit Committee met on May 31 and participated in the State Auditor's entrance conference for the fiscal year 2006 audit, received results of an internal audit of the information services network security, and reviewed the fiscal year 2006-2007 proposed internal audit plan.

Treasurer Murphy moved that the Board accept the Audit Committee's recommendation to approve the Fiscal Year 2006-2007 Internal Audit Plan. Mr. Scott seconded and the motion carried unanimously.

Treasurer Murphy reported that the Committee discussed the need to increase resources to internal audit, which the Board approved when it took action on staff's budget proposal earlier on the agenda.

The Assistant Attorney General's annual conflict of interest review showed that Board members and staff were in full compliance with the Conflict of Interest Policy during calendar year 2005.

Treasurer Murphy moved that the Board accept the Audit Committee's recommendation to accept the Assistant Attorney General's Conflict of Interest Report for 2005. Mr. Scott seconded and the motion carried unanimously.

The Committee received a Board policy compliance review, which showed a high degree of compliance. Treasurer Murphy reported that a new Human Resource policy and some modifications to existing policies would be recommended to the Board as a result of the compliance review.

Faculty from Seattle University presented a proposal for a governance presentation at the July Board meeting. Staff is currently negotiating a contract to procure their services.

The Committee reviewed staff's rationale and plan for the WSIB to voluntarily comply with certain sections of Sarbanes-Oxley. This initiative is proposed as a 2007 strategic plan project, with a detailed plan to be reviewed at the December Audit Committee meeting.

Treasurer Murphy moved that the Board accept the Audit Committee's recommendation to approve staff's preliminary plan to voluntarily comply with relevant sections of Sarbanes Oxley Section 404. Mr. Scott seconded the motion.

Mr. Dear explained that staff seeks voluntary compliance to provide assurance that WSIB operations are conducted in full compliance with regulations and have appropriate control systems in place. Voluntary compliance also places the Board in a stronger position to insist that corporate America comply. Washington is among a few other state pension plans, including California, to seek voluntary compliance.

The above motion carried unanimously.

Treasurer Murphy reported that the Committee approved a scope of work for the fiscal year 2006 financial statement and appointed Peterson Sullivan to conduct the independent audit. It also reviewed the status of outstanding audit recommendations and provided input on the annual evaluation of the internal auditor.

BOARD ADOPTED POLICY REVIEW

Mr. Dear said that Board development and review of its policies and charters is important to becoming a principle-driven organization. Some policy modifications presented by staff are proposed based on a compliance review and in light of actual experience since the major re-write and establishment of policies and charters three years ago. Mr. Dear reported that there were very few areas of non-compliance. He said that staff's categorized its review of policies and charters by: (1) content changes, (2) minor changes, (3) format and citation changes, and (4) no changes recommended.

Mr. Dear described the proposed change to the Conflict of Interest Policy 2.00.100, which would provide for internal agency reporting of financial statements by investment officers rather than requiring Public Disclosure Commission (PDC) filing. Mr. Dear noted that staff who are statutorily required to report to the PDC would continue to do so.

Treasurer Murphy said that the Office of the State Treasurer requires its staff with investment management responsibility to file publicly and stated that he would not support the proposed policy revision. In response to Mr. Masten's question, Mr. Dear said that the Board did not have to act on policy revisions today, but could defer them to the July meeting or to a Committee for review.

> **Treasurer Murphy moved that the Board refer the Conflict of Interest Policy 2.00.100 to the Audit Committee for review. Chair McElligott seconded the motion.**

Mr. Weeks suggested that policy discussion occur at the July meeting, rather than individually referring policies to Committees.

> **Chair McElligott withdrew his support for the above motion.**

> **Treasurer Murphy amended the motion to defer action on the Conflict of Interest Policy 2.00.100 to the July Board meeting. Chair McElligott seconded.**

Mr. Dear described changes made to the Soft Dollar/Directed Brokerage, Real Estate Program, and Developmental Disabilities Endowment Trust Fund policies. Mr. Masten said that he would be more comfortable if all policies were deferred to the July meeting to allow him time to review and decide how to act on the proposed revisions. Mr. Kaminski supported deferral to the July meeting, stating it is a natural time to address policies with governance and private equity best practices on the agenda.

> **Mr. McElligott withdrew his support for the above motion.**

> **Mr. Masten moved that the Board defer action on the Board Policy Reviews and Adoptions to the July meeting. Ms. Matheson seconded and the motion carried unanimously.**

Chair McElligott directed members to review the policies containing minor changes and format and citation changes and plan to act on these as grouped recommendations. He said that the Board would engage in discussions of the four policies containing content changes, as well as the proposed new policy adoptions. He requested that the July agenda include a review of policies following the Board self-evaluation, and to lengthen the meeting time until 3:00 p.m. on July 20.

[Mr. Scott departed at 11:30 a.m.]

STAFF'S REPORT

Executive Director's Report

Mr. Dear provided his monthly report for June on Board governance, staff, investments, budget, operations, public affairs, legislation, and open procurement activities. An updated agenda for the July Board meeting was distributed.

Monthly Investment Report
Mr. Bruebaker reported that the U.S. equity portfolio lost 3.2 percent in May, outperforming the benchmark by 1 basis point for the month and by five basis points for the year ended May 31, 2006. The international equity portfolio lost 4.7 percent for month, outperforming the benchmark by 5 basis points for the month, while underperforming by 73 basis points for the year. He reported that emerging markets was down by 10.48 percent for the month of May, and by 11.3 percent for the first 13 days of June. He noted that developed markets returned over 29 percent in the last year, and emerging markets returned 49 percent.

The CTF fixed income investment portfolio lost 10 basis points for the month, outperforming the outperformance of the Lehman Universal by 4 basis points. Performance was helped by its short duration as interest rates rose. CTF government outperformed index governments by 29 basis points due to positive TIPs performance. The one-year performance has outperformed the Universal by 42 basis points. Private equity returned 3.2 percent for the month. Draws were $130 million, all of which came from the LP portfolio. Average monthly draws for 2005 were $186 million. Distributions for May were $375 million, with $104 million from KKR and $271 million from the LP portfolio. Average monthly distributions for 2005 were $223 million. The HIPEP V Asia Pacific and Rest of World Partnership Fund and OVP Venture Partners VII closed during May at $75 million and $40 million respectively. Real estate returned 20 basis points for the month. Draws were at $39 million, with the average monthly draws for 2005 at $71 million. Distributions during May were $31 million, with the average monthly distributions for 2005 at $108 million. Mr. Bruebaker said that cash was the second highest performer for the month of May with a return of 40 basis points.

OTHER ITEMS
Ms. Matheson announced that DRS celebrated the establishment of the Public Safety Employees' Retirement System, which starts July 1. It is the fifteenth plan under management by DRS.

There was no further business to come before the Board. The meeting adjourned at 11:39 a.m.

Pat McElligott
Chair

ATTEST

Joseph A. Dear
Executive Director