

**WASHINGTON STATE INVESTMENT BOARD**  
**Board Meeting Minutes**  
**July 18-20, 2006**

The Washington State Investment Board met in the Olympic Room at the Inn at Port Ludlow, Port Ludlow, 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  
Dave Scott  
Jeff Seely  
Representative Helen Sommers  
Gary Weeks

Absent: John Magnuson

Also Present: Joe Dear, Executive Director  
Gary Bruebaker, Chief Investment Officer  
Kristi Haines, Executive Assistant  
Paul Silver, Assistant Attorney General

Howard Marks, Oaktree Capital Management LLC  
Kurt Winkelmann, Goldman Sachs  
Beth Cobert, McKinsey & Co.  
Robert Palter, McKinsey & Co.  
Bruno Roy, McKinsey & Co.  
Jim Coulter, Texas Pacific Group  
Dana Gold, Seattle University Law School  
Professor Eric Chiappinelli, Seattle University Law School  
Professor Russell Powell, Seattle University Law School

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

The Board gathered for a dinner presentation at 7:00 p.m. on July 18, 2006.

**INVESTMENT MANAGEMENT, RISK AND DISTRESSED DEBT**

Mr. Marks presented information on investment management, risk and distressed debt.

Chair McElligott called the business meeting into open public session at 8:37 a.m. on July 19, 2006, and took roll call. Board members, staff, and retreat attendees introduced themselves.

## **ADOPTION OF MINUTES – JUNE 15, 2006**

**Vice Chair Gorton moved to adopt the June 15, 2006, Board minutes as submitted. Mr. Scott seconded and the motion carried unanimously.**

### **PUBLIC COMMENT**

There was no public comment.

### **STRATEGIC PLANNING FRAMEWORK AND REVIEW**

Mr. Dear provided his monthly report on Board governance, staffing, and open procurement activities. He reviewed the WSIB's strategic direction, investment performance as of June 30, 2006, and the strategic themes for 2006, which are: (1) rigorous focus on investment performance and decision making; (2) achieve exemplary governance; and (3) develop, inspire, and support people who are passionate about investment management. He described and updated the Board on staff projects that support each of the strategic themes. Mr. Dear asked the Board to consider strategies during the retreat on how the WSIB can transition from being "good to great."

[The Board recessed at 9:17 a.m. and reconvened at 9:40 a.m.]

### **RISK PRESENTATION**

Mr. Winkelmann provided an introduction to risk budgeting. He said that risk budgeting provides a tool for designing investment policy because risk is more easily identified than return. Risk budgeting is the allocation of portfolio risk to each exposure and expresses the investor's views on risk and return. Mr. Winkelmann described how risk frames help set the governance structure. He applied relevant risk budget tools to the WSIB's asset allocation by market and active risk, market exposures, strategy, and individual asset-class levels to demonstrate applicability. A discussion ensued on how risk budgeting applies in manager selection.

[The Board recessed at 11:11 a.m. and reconvened at 11:32 a.m.]

### **RISK DISCUSSION**

Mr. Dear reported that the agency's Enterprise Risk Management (ERM) system shows that the WSIB is doing very well from an operational standpoint, but it has exposed work needed within investment management. Mr. Dear said he likes a risk budgeting approach and wants to explore where the agency is at currently, and engage the Board in becoming more strategic. He suggested that the Board may consider adopting a risk budget tool and framework to provide more flexibility at the staff level with monitoring at the Board level, and to clarify accountability for decision making. Mr. Dear said he would like to begin risk management work this fall and put it into next year's strategic plan.

Chair McElligott pointed out that the WSIB was innovators with its private equity and real estate programs. Mr. Dear noted the recent decision with regard to real estate operating company strategy. Chair McElligott said that risks taken by the WSIB have made it unique. Both he and Mr. Masten share the opinion that the Board's risk tolerance is higher than staff's. Chair McElligott emphasized that the Board tries to get the best returns for its beneficiaries based on the facts and figures, and that known risks can be better managed.

In response to Representative Sommers' question as to the average long-term assumption rates among public pension funds, Ms. Matheson reported that the average is 8 percent, which is the assumption used by Washington State. A discussion ensued relating to WSIB's top quartile performance compared to public funds and endowments and how top decile performers manage risk. Mr. Weeks observed that risk tolerances for portfolios other than the commingled trust fund are different and education is needed on those strategies.

Mr. Nierenberg said he would like to see the Board identify four to five strategies that could have the greatest impact and define what number takes the WSIB from good to great. He noted a particular importance to identify strategies within private equity and real estate.

A discussion ensued about risk tolerance, the different perspectives and experiences of Board members, developing investment beliefs, and personal responsibility in decision making. Mr. Kaminski and Treasurer Murphy agreed that a decision-making framework should be developed.

[The Board recessed at 12:06 p.m. and reconvened at 1:04 p.m.]

#### **PRIVATE EQUITY BEST PRACTICES STUDY**

Mr. Roy, Mr. Palter, and Ms. Cobert presented information on McKinsey & Company's study of the WSIB's private equity processes. Ms. Cobert provided an overview of the McKinsey organization. Mr. Palter reported on McKinsey's core beliefs about institutional investing, leaders they have researched, and shared characteristics among outperformers. Mr. Roy summarized the findings and recommendations of their best practice study relating to investment and institutional strategy. A discussion ensued regarding the Private Markets Committee and McKinsey's observation that the communications with general partners could be improved by a change in the meeting format. Treasurer Murphy said he is opposed to excluding the McKinsey & Company study from the public record. Mr. Bruebaker said that a public document is available. He preferred not to share confidential business information with our competition.

[The Board recessed at 2:50 p.m. and reconvened at 3:07 p.m.]

Mr. Roy continued to summarize McKinsey's study findings and best practice recommendations for private equity investment processes and organization. Mr. Roy reviewed the recommendations to staff to refine their strategy, enhance the investment process, and rethink the organization. He provided McKinsey's rationale for each recommendation and listed out questions for the Board to consider going forward

Members shared their opinions on the recommendations and gave suggestions for further consideration. Mr. Kaminski said he would like staff to consider small venture capital fund investments within the Innovation Portfolio.

[The Board adjourned its business meeting at 4:28 p.m. and gathered for a dinner presentation at 7:00 p.m.]

#### **PRESENTATION**

Mr. Coulter presented information on the elements of a successful and effective board and provided an overview of private equity strategies.

Chair McElligott reconvened the business meeting at 8:33 a.m. on July 20, 2006, and took roll call.

[Mr. Nakahara was in attendance on July 20.]

### **GOVERNANCE OVERVIEW AND BEST PRACTICES**

Mr. Dear introduced Ms. Gold, Professor Chiappinelli, and Professor Powell of Seattle University. Ms. Gold provided an overview of the governance presentation and thanked the Board for the invitation to attend and observe its business meeting on July 19.

Professor Powell reviewed the WSIB's policy on corporate governance. He suggested that boards care about good governance because it affects returns; therefore adding value, and due to personal liability reasons. He noted the importance of the Board's Conflict of Interest Policy. He said that four major areas of good governance include: stakeholder relations, disclosure, Board structure, and principles that provide context for rules. He described a board's role to provide oversight, collaborate with staff, focus on where value can be added, and to monitor issues. He said that good boards rely on their experts (staff) to perform the daily work. Professor Powell described why some boards fail to achieve good governance. He said he was pleased that the WSIB seeks to voluntarily comply with Sarbanes Oxley, Section 404.

Professor Powell reviewed the Board's fiduciary duty and standard of care. He noted that the WSIB's standards for its members are much higher than what is seen in the private sector. A discussion ensued regarding the prudent investor versus prudent person standard, and liabilities statutes. Good processes are essential to ensure decisions are made in the best interest of beneficiaries.

Mr. Nakahara suggested that the Board should define its minimum standard of care. Mr. Nierenberg observed that these best practices support his suggestion that the Board should consider delegating investment decisions up to a specific dollar amount to staff, so that Board members act at the trustee level.

Professor Powell said that what the Board chooses to deal with directly is a major question. He emphasized the importance of having information reporting systems in place for delegation and monitoring by the Board.

A discussion ensued regarding retention of meeting minutes. Mr. Dear advised members of the retention schedule currently in place, and confirmed that the Board controls that schedule. Mr. Masten suggested that retention issues could be addressed at a future meeting.

Mr. Nierenberg suggested a future discussion of potential liability issues that may arise when staff and the Board disagree on an investment commitment level.

Professor Powell reviewed different outcomes of governance issues at Disney and Enron. He indicated that the size of impact to others within an organization plays a role even if fiduciary duty is not part of the issue.

[The Board recessed at 9:47 a.m. and reconvened at 10:04 a.m.]

Ms. Gold reviewed the guiding principles to consider in building an effective board: commitment to legal compliance with fiduciary duties, adherence to the highest ethical standards by individuals and organization, commitment by the board and individual members to learning about the health of the organization through active engagement in strategy and oversight, and evaluation of the board's effectiveness. She made note of principles already in place within the WSIB, and highlighted some which may present a challenge to the Board.

Mr. Nierenberg suggested that staff prepare a write-up for the Board's consideration of conducting closed working sessions versus open public meetings for the Private Markets Committee. Chair McElligott directed Mr. Dear to work with the Private Markets Committee Chair to define circumstances when an executive session would be appropriate. Chair McElligott asked to have the process tested at the next Private Markets Committee meeting with appropriate public notice. George Masten stated that he did not believe we needed any staff write-up for Board consideration and that while he was skeptical that closed sessions were needed, he was open to closing portions of the meeting to see if the discussions are in fact more robust.

Ms. Gold presented information on board models ranging from least to most involved boards, with the "engaged board" (middle of the chart) as an ideal. An engaged Board deals with risk, fulfills its fiduciary duty, and has investment beliefs and strategies in place. She introduced a checklist for an ideal board and reviewed code of conduct for boardroom behavior.

#### **GOVERNANCE FRAMEWORK FOR THE WSIB**

Ms. Gold invited members to share their perspectives on governance issues within the WSIB.

Mr. Kaminski suggested that new members should attend the Seattle University Corporate Governance course upon joining the Board.

Members suggested that the Board set its own agenda, improve time management within the agenda, consider consent agendas, and pre-plan issues for in-depth discussion during the year.

Representative Sommers pointed out that staff had already begun work on a number of items within the McKinsey study and she believes the Board could move from good to great by implementing their recommendations. She said that increasing discussion time at Board meetings would require a cultural change among some members who tend to depart meetings early.

Ms. Matheson suggested that the Board look at its strategy and oversight to consider how it has or should change due to organizational growth.

Senator Brown said that the Board should set out explicit investment beliefs for the private equity program. Mr. Nierenberg recommended that the Board should articulate beliefs applying to each asset class, as well as diversification among the classes.

Mr. Weeks suggested each meeting should include one issue to explore in depth. He pointed out that members had taken thoughtful positions on issues during this meeting, which resulted in better discussion than tends to occur at regular meetings. He said it would be helpful for the Board to look at conducting its meetings at a different time.

Treasurer Murphy explained how OST staff annually examines its work methods to see if there are other practices that make more sense. He indicated his support for a change in the Board meeting time.

Chair McElligott commented that he enjoys the annual off-site meeting, but the regular Board and Committee meetings are important and quorum issues are problematic. He understands the difficulty in members taking time away from their regular jobs to attend meetings. One change he tried recently was to move an education sessions earlier on the Board agenda to improve member attendance. He said that there are only a few items listed on the Seattle University governance checklist that he would like to see the Board do differently.

Mr. Dear said that staff would like more involvement from the Board at a higher level. The education sessions are important in taking the Board to this level. He said that plans for upcoming education sessions include liability, investment beliefs for private equity and risk, and work on the private equity and real estate plans. He said that staff begins planning for 2007 at the end of August. Staff tries hard to do good staff work and he admits that this may result in what seems to be presenting the Board with a “baked cake.” He observed that staff should instead present the Board with “the menu.”

Mr. Masten indicated his support for more discussion time on the agenda, but pointed out that member attendance is a key issue. He reiterated that he prefers not to conduct business via teleconference. He asserted that members regularly attending meetings and staff-planned training sessions would improve the Board.

Senator Brown indicated that scheduling Board meetings in the evening would improve her ability to attend, especially during legislative sessions.

[The Board recessed at 11:55 a.m. Chair McElligott said that the Board would reconvene in executive session at 12:15 p.m.]

### **BOARD EVALUATION DISCUSSION AND FEEDBACK**

Chair McElligott called the Board into executive session at 12:15 p.m. He said the purpose of the executive session was to review and discuss the performance of the Board. He said that only Board members would participate in the session, which would last approximately 30 minutes.

[The executive session concluded at 1:42 p.m. the Board took a brief recess, and reconvened the open public session at 1:53 p.m.]

### **BOARD ADOPTED POLICY REVIEWS AND ADOPTIONS**

Mr. Dear said that staff had reviewed all Board policies as required by policy. Staff grouped its proposed policy changes into three categories: four policies requiring content change (Conflict of Interest, Soft Dollar/Directed Brokerage, Real Estate Investment Program, and Developmental Disabilities Endowment Trust Fund), 17 policies with minor change recommendations, and 12 policies with format and citation changes only. In addition to staff’s policy content review, Mr. Dear said that a compliance review was completed and reported on at the May 31 Audit Committee meeting. The compliance review found that the Board had not established a broad based human resource policy, or a communications policy. Staff’s proposal for Human Resources

Policy 2.00.000 and Communications Policy 2.00.175 were submitted for the Board's consideration. Additionally, the Administrative Committee had requested that staff prepare a draft policy on outside employment. A draft Outside Employment Policy 2.00.101 was submitted for the Board's consideration, in addition to an alternate version staff prepared at the request of Treasurer Murphy.

Chair McElligott said that while human resource issues are covered by statute, it is a good idea to have a broad based policy in place. Chair Murphy said that the Audit Committee had also discussed the need for a human resource policy.

**Treasurer Murphy moved that the Board adopt Human Resource Policy 2.00.000. Vice Chair Gorton seconded and the motion carried unanimously.**

Mr. Dear said that several current Board policies discuss elements of communication, and that the proposed draft sets forth a general policy.

**Mr. Masten moved that the Board adopt Communications Policy 2.00.175. Treasurer Murphy seconded and the motion carried unanimously.**

Mr. Dear reported on the four policies staff recommends for content change. He said that the Conflict of Interest Policy proposed revision would have staff members, who are not statutorily required to report to the Public Disclosure Commission (PDC), file their Statement of Financial Affairs instead to the WSIB executive director. The current Board policy requires all staff with investment management responsibility to file annual reports to the PDC.

**Treasurer Murphy moved that the Board accept the proposed policy content changes staff recommends to Directed Brokerage Policy 2.05.700, which rescinds the Soft Dollar Policy 2.05.400; Real Estate Investment Program Policy 2.10.600; and Developmental Disabilities Endowment Trust Fund Policy 2.35.400. Vice Chair Gorton seconded the motion.**

Treasurer Murphy suggested that the Board separately discuss the proposed revisions to the Conflict of Interest Policy 2.00.100.

**The above motion carried unanimously.**

**Mr. Masten moved that the Board accept the proposed changes to the Conflict of Interest Policy 2.00.100, with the exception of the proposed changes on page 7, under section D.2, Monitoring, Statement of Financial Affairs. Ms. Matheson seconded the motion.**

Mr. Dear explained the reason for the proposed revision. Staff pointed out issues with exposure of financial information and the potential for fraud, which could be especially problematic for individuals with common names. Mr. Nierenberg said that his company's policy is that employees do not hold any investment in companies in which his firm is invested within their personal portfolios. He said he feels strongly about transparency issues. Senator Brown and Treasurer Murphy said that staff's situation for potential exposure is no different than Board

members and they want staff with investment management responsibility to continue to file their financial information publicly.

**The above motion carried unanimously.**

Chair McElligott asked the Board to consider the list of policies to which staff had recommended minor changes.

**Vice Chair Gorton moved that the Board accept the minor policy changes recommended by staff as referenced in the Board packet materials (copy attached). Mr. Weeks seconded and the motion carried unanimously.**

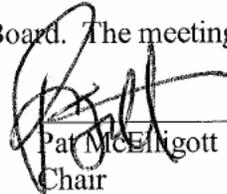
Chair McElligott asked the Board to consider the list of policies to which staff had indicated that format and citation changes were needed.

**Mr. Masten moved that the Board accept the format and citation changes noted by staff as reference in the Board packet materials (copy attached). Vice Chair Gorton seconded and the motion carried unanimously.**

**OTHER ITEMS**

Mr. Nierenberg said that he thoroughly enjoyed his first Board retreat and found it to be very productive. Treasurer Murphy thanked Mr. Nierenberg for his contribution to the retreat. Senator Brown thanked Chair McElligott for keeping the Board on task.

There was no further business to come before the Board. The meeting adjourned at 2:14 p.m.

  
\_\_\_\_\_  
Pat McElligott  
Chair

ATTEST

  
\_\_\_\_\_  
Joseph A. Dear  
Executive Director