STATE INVESTMENT BOARD
Board Meeting Minutes
September 21, 2006

The Washington State Investment Board met in open public session at 9:30 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 George Masten Sandy Matheson Bob Nakahara David Nierenberg Mason Petit Dave Scott (via teleconference) Jeff Seely Gary Weeks
Absent:	Treasurer Mike Murphy Representative Helen Sommers
Also Present:	Joe Dear, Executive Director Gary Bruebaker, Chief Investment Officer Kristi Haines, Executive Assistant Tom Ruggels, Senior Investment Officer – Private Equity Steve Draper, Senior Investment Officer – Real Estate Paul Silver, Assistant Attorney General David Woolford, Capital Dynamics Michael Humphrey, Courtland Partners Joe Cook, Courtland Partners Mike Heale, Cost Effectiveness Measurement

[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.

OATH OF OFFICE FOR NEW BOARD MEMBER

Chair McElligott administered the oath of office to Mr. Mason Petit who was appointed to fill the unexpired term of the active PERS member position on the Board through December 31, 2008.

ADOPTION OF THE JULY 19-20, 2006 MINUTES

Mr. Masten moved to adopt the July 19-20, 2006, Board minutes. Vice Chair Gorton seconded the motion.

Mr. Kaminski noted a correction on page 4, under Private Equity Best Practices Study, in the last paragraph, that his statement was that he would like the Board to consider positions in small venture capital for the Innovation Portfolio, not venture capital fund-of-funds. He also asked that the minutes reflect that the Board Evaluation Discussion and Feedback executive session on July 20 was held with Board members only.

The motion to adopt the minutes with the above noted corrections carried unanimously.

PUBLIC COMMENT

There was no public comment.

CHAIR/VICE CHAIR ELECTIONS

Mr. Gorton nominated Mr. McElligott as Chair for another one-year term. There were no further nominations and Mr. McElligott was declared Board Chair by acclamation.

Chair McElligott nominated Mr. Gorton as Vice Chair for another one-year term. There were no further nominations and Chair McElligott declared Mr. Gorton as Board Vice Chair by acclamation.

Chair McElligott announced a change in agenda order. He asked Mr. Masten to present the investment recommendations from the Private Markets Committee Report.

PRIVATE MARKETS COMMITTEE REPORT

Real Estate Investment Recommendation – Prosperitas Real Estate Partners I

Mr. Masten reported that the Committee recommends an investment of up to $50 million in Prosperitas Real Estate Partners I (PREP I), based, in part, on the following: (1) Brazil is the fifth most populous nation in the world, with a population of nearly 185 million. Approximately 47 percent of Brazil's population is under the age of 26 years. As this generation of Brazilians age, gain employment, and create new households, they also will increase demand for all types of real estate, especially residential property. The growth and stabilization of Brazil's economy has fostered rising levels of personal income and, very importantly, a strong and rapidly growing middle class. (2) Brazil's strong economic growth over the past 15 years reflects the government's success in addressing a range of challenges that historically have hampered its economic development, including high inflation, increasing levels of public debt, and a depreciating currency. The country currently has a widening positive trade imbalance. (3) With its stable democratic government, growing domestic markets, abundant low-cost labor, and expanding export opportunities, Brazil has attracted the attention of multi-national corporations and investors. These factors have created significant unmet demands for quality office space in major cities. Modern housing is also dramatically under-supplied, as Brazil faces a current shortage of over 6 million residential units. (4) The Fund has an attractive strategy. Much of the Fund's capital will focus on opportunities with lower real estate risks, helping to offset the added risks of emerging markets investing. (5) The team appears to be cohesive and possesses excellent investment and management skills, and seems to have a very good reputation and a large contact base within the local market. (6) In recent years, Brazil has shown tremendous momentum in strengthening and stabilizing its economy. An investment in PREP I will give the WSIB an opportunity to enter a rising, undersupplied market with limited competition from other institutional investors at this time, and (7) the WSIB may be offered the opportunity to co-invest with the Fund on transactions requiring a commitment too large for the Fund.

Mr. Masten moved that the Board accept the Private Market Committee's recommendation to invest up to $50 million, plus fees and expenses, in Prosperitas Real Estate Partners I, L.P. (Reais Fund), subject to ongoing due diligence and final negotiation of terms and conditions. Vice Chair Gorton seconded and the motion carried unanimously.

Real Estate Investment Recommendation – Indochina Land Holdings 2

Mr. Masten reported that the Committee recommends an investment of up to $25 million in Indochina Land Holdings 2 (ILH2), based, in part, on the following: (1) The Vietnamese market is attractive. The WSIB real estate strategy has a strong focus on growth markets, both within the U.S. and globally. A particular focus of the portfolio is expansion into additional emerging markets. ILH2's strategy will provide the WSIB with investments in a market where high levels of growth are expected, demand for real estate of all types is exceptionally high, supply is insufficient to meet that demand, and competition is negligible at this time. (2) In general, Vietnam has a very rapidly growing economy and an expanding middle class. The country is anticipated to receive World Trade Organization membership in the next few months, further improving long-term prospects. The market is underserved in nearly all property types. (3) The management team is seasoned and experienced. Peter Ryder and Rick Mayo-Smith have both lived and invested in Vietnam for the past 14 years. Each is deeply connected in the local business markets and has extensive key contacts within the government. (4) The investment has an attractive strategy. ILH2's strategy for the Vietnamese market focuses primarily on three areas: for-sale residential development, mixed-use urban properties, and hospitality properties. (5) The WSIB may be offered the opportunity to participate in co-investment opportunities alongside the Fund. This may allow the WSIB to focus more investment dollars in deals that have attributes most attractive to the WSIB general real estate strategy. (6) ILH2 will initially have almost no institutional competition for deal flow, being at the forefront of the Vietnamese opportunity. This is an opportunity to partner with a high-profile market leader in an up-and-coming economy, and to get in on the ground floor with them.

Mr. Masten moved that the Board accept the Private Markets Committee's recommendation to invest up to $25 million, plus fees and expenses, in Indochina Land Holdings 2, L.P., subject to continued due diligence and final negotiation of terms and conditions. Vice Chair Gorton seconded the motion.

Mr. Masten noted that there is possibility of doing co-investments with this general partner, which could provide an opportunity to make additional investments with higher return than the current recommendation. He noted that Indochina Land Holdings 2, L.P. projects a net IRR of 25 percent.

The above motion carried unanimously.

Chair McElligott announced that the Public Markets Committee Report would be presented next. [Senator Brown was in attendance at 9:44 a.m.]

PUBLIC MARKETS COMMITTEE REPORT – PORTABLE ALPHA RELATED INDEX IMPLEMENTATION

Mr. Bruebaker reported that a portable alpha strategy for the U.S. equity program was recommended by consensus at the April Public Markets Committee. The Board tabled the issue in April due to its concern with potential tracking errors using the Russell 3000 index. The Chair directed staff to report back on the proposal in September. Mr. Bruebaker announced that there is currently an opportunity to implement the strategy using the Wilshire 5000 index.

Mr. Bruebaker described that the WSIB would contribute shares of the U.S. index fund to an asset trust created by Barclays Global Investors (BGI). The WSIB will receive preference shares from the trust in return, which will be paid the return of the Wilshire 5000, plus a premium of 15 basis points. There are no management fees, transition fees, nor participation in securities lending or shares to vote. The trust is initially collateralized at 185 percent with triggers in place to prevent it from becoming under-collateralized and has an option to liquidate. In response to a concern expressed by Mr. Kaminski, Mr. Bruebaker advised that BGI serves as trustee for the WSIB's interests and any change in strategy which would jeopardize the collateral to unsafe levels would require WSIB approval. He said the portable alpha strategy had been tested to five standard deviations.

In response to Mr. Masten's questions, Mr. Bruebaker clarified that BGI would transition assets they receive from the WSIB into other equity assets for which participants on the other side would vote the shares. He indicated that, while the proposal is to invest up to 25 percent of the U.S. equity indexed assets, he does not foresee ever reaching that percentage level.
Mr. Nierenberg spoke in favor of the proposal for the U.S. equity or other parts of the portfolio.

Chair McElligott moved that the Board adopt the portable alpha concept as a Preference Shareholder with a total investment of up to 25 percent of the CTF U.S. equity indexed assets (at time of purchase), subject to continued due diligence and successful negotiation of terms and conditions.
Vice Chair Gorton seconded and the motion carried unanimously.

Chair McElligott announced that the Audit Committee Report would be presented next.

AUDIT COMMITTEE REPORT

Mr. Masten reported that a consultant representative from Seitel Leeds, the consultant who performed a review of the WSIB Information Services Network Security, presented the results of their vulnerability assessment to the Committee in executive session. The consultant found all vulnerabilities had been mitigated or are on schedule to be mitigated.

Internal Audit Report 2006-03, Private Equity Consultant
Mr. Masten announced that the overall assessment of the internal audit of Capital Dynamics, the Board's new private equity consultant, was good. The audit scope included Capital Dynamics' internal governance, contract services, and internal controls over WSIB accounting data.

> **Mr. Masten moved that the Board accept the Audit Committee's recommendation to approve the Private Equity Consultant Internal Audit Report 2006-03. Vice Chair Gorton seconded the motion.**

Mr. Masten said that there were a few issues identified during the audit that needed further work, and both the internal auditor and Committee are satisfied that improvements are being implemented in those areas.

> **The above motion carried unanimously.**

Mr. Masten reported that two nonvoting Board member's terms will expire on December 31, 2006, Mr. Charlie Kaminski and Mr. John Magnuson. Both members have provided letters of interest expressing their desire to serve another term on the Board.

> **Mr. Masten moved that the Board accept the Audit Committee's recommendation to re-appoint Charlie Kaminski and John Magnuson for three year terms from January 1, 2007 to December 31, 2009. Vice Chair Gorton seconded and the motion carried unanimously.**

Mr. Masten reported that the Committee recommends having Seattle University School of Law staff provide a follow-up assessment of their observations from the July Board Retreat.

> **Mr. Masten moved that the Board accept the Audit Committee's suggestion to have faculty present observations and an assessment of the Board's governance at a future Board meeting. Ms. Matheson seconded and the motion carried unanimously.**

Mr. Masten reported that the Committee also received a status report on outstanding internal audit recommendations and received reports on corporate governance activities with regard to majority voting, executive compensation and efforts to ensure that the WSIB is not invested with companies doing business in Sudan. Lastly, the Committee approved a scope of work assignment for Peterson Sullivan relating to the WSIB's effort to become a voluntary complier with Sarbanes Oxley Section 404.

[Senator Brown was no longer in attendance at 10:03 a.m.]

QUARTERLY PERFORMANCE REPORTS

WSIB Managed Funds

Mr. Bruebaker presented the quarterly report for the Commingled Trust Fund (CTF) for the period ended June 30, 2006. Large cap outperformed small cap as measured by the Russell 2000, value outperformed growth using the Russell 3000 series, international markets outperformed the U.S. equity market as measured by the MSCI ACWI ex U.S. index, the gross domestic product was at 2.9 percent and inflation was up 1.3 percent for the quarter as measured by CPI. The Feds continue to have some concerns with inflation and there is discussion of growth slowing globally.

The Wilshire 5000 is up through June at 9.9 percent. Longer term performance for capital markets still looks good. The yield curve from June 30, 2005, through June 30, 2006, shows a shift up as a result of 17 continuous Fed increases. There was a slight shift down since June 30, 2006, as the Feds have held two meetings since then where there was no action taken.

Fund performance of 16.7 percent for the year beat all measures, including implementation value added (IVA) which is difficult to beat. The IVA shows how much of the out or underperformance is attributed to asset allocation and manager selection. Mr. Bruebaker said that the WSIB CTF also beat Oregon's performance for the quarter, one-, three- and five-year. Mr. Bruebaker reported that U.S. equity has behaved as one would expect an index to behave. Longer term performance in international was not good due to underweighting in emerging markets. The portfolio remains underweight in emerging. International equity developed is in line with the benchmark. Mondrian was the best performing international active developed manager with a 3.1 percent return, outperforming the benchmark by 243 basis points (bps); William Blair had the worst performance losing 2.6 percent, underperforming the benchmark by 328 bps. The second quarter was not good for emerging markets. Pictet had the worst performance losing 5.6 percent, underperforming the benchmark by 129 bps. Lazard performed the best, but still lost 3.4 percent. Chair McElligott asked if staff was tracking the performance of Julius Baer and William Blair. Mr. Bruebaker replied affirmatively and said that both managers' longer term performance is good.

Mr. Bruebaker reported that fixed income outperformed the benchmark for the quarter, one-, three-, five- and ten-year by 18, 58, 25, 30 and 34 bps respectively. He acknowledged the outstanding work of the Fixed Income team.

Private Equity

Mr. Ruggels introduced David Woolford, Managing Director of Capital Dynamics, to present the private equity funds report for the period ended March 31, 2006. This is the first quarterly report prepared and presented by Capital Dynamics, the Board's new private equity consultant.

Mr. Woolford provided an activity overview for the quarter. The WSIB set a new record for commitments authorized. Appreciation was $563 million for the fourth quarter, which is strong performance.

Mr. Woolford said that he would follow the format of previous consultant reports, breaking out KKR from the rest of the LP portfolio. He said that KKR investments comprise 27 percent of the total valuation of the portfolio. KKR provided 41 percent of distributions and 32 percent of appreciation, which is excellent performance. Both KKR and the LP portfolio are performing well. The LP portfolio has a significant number of funds and styles that provide diversification.

The WSIB authorized nine new investments and closed six commitments, which includes one authorized in the fourth quarter of 2005. Appreciation was largely driven by the four largest positions in the portfolio: KKR, Fortress, Warburg Pincus and Madison Dearborn. There were no large declines in fund value to report.

For subsector allocation, only venture capital is below target. This can be attributed to the large scale of the portfolio and more attractive opportunities in international and corporate finance opportunities. Industry allocation is highly diversified. Two notable increases since 2005 were to information technology and financials; there was a decrease in materials. For general partner style performance, corporate finance, international, distressed and direct secondary subsectors have been top performers over the last three years.

A discussion ensued regarding the increasing trend of club deals. Mr. Nierenberg stated that club deals could result in a concentration and suggested that the Board may want to further discuss this risk. Mr. Dear noted it for discussion during the upcoming private equity allocation planning session.

Mr. Woolford reviewed the market environment. U.S. buyouts and mezzanine fundraising has soared and European fundraising is also reaching records. Venture capital fundraising has increased steadily within the U.S. with a focus on later stage investments and the healthcare industry. He discussed the resulting affect on overhang.

Real Estate

Mr. Draper introduced Michael Humphrey and Joe Cook of Courtland Partners, who presented the real estate funds report for the period ended March 31, 2006.

Mr. Cook reported that the real estate portfolio ending value for the quarter was $5.5 billion, reflecting a 19 percent increase. He reviewed components contributing to portfolio growth over the six month period ended March 31, which was mainly income and appreciation totaling slightly over $500 million; for example, manufactured housing and non-performing loans. Structured finance, health care, and lodging helped to contribute $600 million to the portfolio during the quarter.

Mr. Humphrey reported that portfolio performance was very good, outperforming historical norms at 24.8 percent for the one-year. He does not expect this superior performance is likely to continue. The challenge will be to identify manager who can take advantage of the market conditions.

The operating company investment strategy has worked well within the portfolio. Manufactured housing and residential investments were timed well. Opportunistic investments in Asia, such as non-performing loans have had superior returns. European and some domestic investments have provided good income returns. One-third of the portfolio has provided income returns of 8 to 10 percent. The European separate account and timber have performed at less than expected levels.

Timber has seen a slight increase in the one-, three- and five-year returns due to capital coming into the sector. Mr. Humphrey described some of the issues which have affected the timber industry.

Mr. Cook reported that WSIB gross returns are well above the NCREIF and the Courtland database benchmarks for the quarter through the 10-year periods. The portfolio outperformed NCREIF by 9.7 points for the one-year and by 5.7 points for the 10-year.
Mr. Seely pointed out slight differences in real estate numbers stated in the staff versus Courtland reports for the 5- and 10-year periods. Mr. Bruebaker explained that events that come to staff's attention during the quarter are recorded in the WSIB books and the quarter dropping out of the report can affect the numbers.

Mr. Humphrey described how cap and vacancy rates, and capital inflows have historically affected real estate pricing. Commenting about the economy in general, he said that an oversupply of housing, the negative savings rate, homeowners mortgaging up to consume, and the increase in variable rate loans may have an impact. He noted a 20 percent increase last year in variable rate loans in single-family housing. In response to Ms. Matheson's question, Mr. Humphrey said that the 20 percent increase includes all new types of financing, such as zero-down and no principal loans. Mr. Humphrey said that these conditions may dampen the economy and inflation is also a concern. Real estate has not always provided a good inflation hedge historically and negative performance could be a result under these circumstances.

Courtland continues to examine the rotation of best performing property type exposure. Courtland believes that alternative and international real estate investments will continue to serve the WSIB well.

Chair McElligott announced that Mr. Weeks would be departing the Board upon his resignation as the Labor and Industries' director. He thanked Mr. Weeks for his contributions while serving on the Board. Mr. Weeks said he enjoyed the opportunity to learn and work with the other members.

[The Board recessed at 11:14 a.m. and reconvened in open public session at 11:47 a.m.]
[Chair McElligott and Mr. Nakahara were no longer in attendance at 11:47 a.m.]

COST EFFECTIVENESS MEASUREMENT REPORT
Mr. Dear introduced Mike Heale of Cost Effectiveness Measurement, Inc. (CEM). He said the CEM is a subscription service that performs a comparison analysis of funds' operations costs and investment performance. Mr. Dear said the analysis is useful with identifying activities that create value, which the Board could consider as focus items in the upcoming strategic planning sessions.

Mr. Heale said the CEM report compares WSIB performance against both CEM's database of 136 U.S. funds, and a custom peer group of 20 funds similar in size to the WSIB. The custom group includes 12 public, 7 corporate and one union-type fund. He said the peer group is primarily the same as what was used last year, with the exception of one fund. CEM's analysis focuses on policy return, implementation value added (IVA), implementation risk, costs, cost effectiveness and asset-liability mismatch risk.

Mr. Heale said the analysis showed that the WSIB's 5-year policy return of 6.1 percent was above the 5.2 percent median of both the U.S. and peer group. This positive impact was due to a higher weighting in real estate and private equity, and a lower policy weight in U.S. stock.

Mr. Heale reported that IVA contributed 3.6 percent of the 2005 returns, which put WSIB in the top quartile. Positive value was added from fixed income, real estate, and private equity. The WSIB's 5-year implementation risk of 2.7 percent was above the U.S. median of 1.3 percent. He noted the WSIB's large weighting in private equity and said that private equity IVA is difficult to assess due to the wide variety of benchmarks used within the U.S.

The WSIB's asset management costs for 2005 were $172.6 million or 35.6 basis points. Fund oversight, trustee and custodial, consulting and performance measurement, audit and other asset related costs are included as asset management costs. The benchmark cost analysis suggests that the WSIB was low cost by -16.8 basis points, or $81 million. This is largely driven by implementation style. Mr. Heale said that the WSIB's external active management is significantly less than the peer group, and he provided a percentage breakdown of the differences by asset class. The WSIB's implementation style choices resulted in a total savings of $32.7 million. Overall, the WSIB is generally paying less for similar services than its peer group, which is very unusual for the WSIB's plan size. The fund also uses lower cost passive and internal management, which results in lower costs. Mr. Bruebaker noted an error in how enhanced managers were classified within CEM's report, which should be fixed going forward.

Mr. Heale said that combining the net IVA and excess cost results in an overall cost effectiveness ranking. The WSIB is ranked as positive value and low cost. Mr. Nierenberg pointed out one of the U.S. funds noted on the chart with exceptional results and said he would be interested to learn what fund it was so the WSIB could determine what the fund is doing to result in their ranking.
Mr. Heale agreed to seek the fund's permission to release that information.

Mr. Heale reported that the asset-liability mismatch uses a neutral asset mix to model marked-to-market liabilities. The neutral asset tool reflects plan average and membership demographics. The WSIB's 5-year liability return of 10.6 percent was above the U.S. median primarily because TIPS yields fell more than nominal bond yields. The WSIB liabilities are more sensitive to inflation than the average U.S. plan. The WSIB's surplus returns show that its marked-to-market liabilities grew faster than assets. A discussion ensued regarding the impact of funding strategies and the importance of considering liabilities in strategic planning. Mr. Heale reported that the asset-liability mismatch risk for the 5-year period was 15.8 percent for the WSIB, 16.8 percent for the U.S. median, and 16.3 percent for the peer group median.

In summary, the WSIB's policy return was 6.1 percent; the 5-year IVA and implementation risk was 0.4 percent and 2.7 percent respectively. The total cost was 35.6 bps, which is below the benchmark cost of 52.3 bps. The cost effectiveness ranking was in the positive value and low cost quadrant. Finally, the 5-year asset-liability mismatch risk was 15.8 percent, which is below the U.S. and peer medians at 16.8 and 16.3 percent respectively.

Mr. Heale reviewed key fund trends and characteristics of top performing funds over the past 10-15 years. Fixed income fell 7 percent while foreign stock, private equity and hedge funds have risen slightly. There has been a shift from internal to external management, which grew 85 percent. Gross and net IVA averaged 61 bps and 24 bps respectively in the global database. Within the U.S., IVA was positive in small cap, foreign and emerging stocks; fixed income; and private equity. Large funds have performed better than small funds. Funds with more internal management did better than those with less. Passive management was beneficial to net value added, while active management reduced it. Finally, no relationship was found between fund type and net value added.

Mr. Nierenberg commented that he would like to see the strategy conversation include a discussion of emerging market, small cap and hedge fund opportunities.

PRIVATE MARKETS COMMITTEE REPORT (continued)
Vice Chair Gorton announced that the Board would go into executive session at 12:40 p.m. to discuss the Real Estate Annual Plan Update and the Private Equity Annual Plan Update since public knowledge regarding the discussion would result in loss to the funds managed by the Board or would result in private loss to providers of information to the WSIB. He estimated that the executive session would last until about 1:40 p.m. at which time the Board will reconvene in open session.

Real Estate Annual Plan Update
Private Equity Annual Plan Update

[The Board reconvened in open public session at 2:06 p.m.]
[Mr. Weeks was no longer in attendance at 1:42 p.m.]
[Mr. Nierenberg was no longer in attendance at 2:10 p.m.]

EXECUTIVE DIRECTOR'S REPORT
Mr. Dear acknowledged Jim Lee, Information Systems Manager, who is retiring from state service on September 30. Mr. Lee has been a dedicated employee and contributed greatly to the enhancement of information systems over his 12 years of service to the agency.

Mr. Dear announced that an Administrative Committee is planned for December 11 to discuss strategy. He invited all members to the meeting to participate in the process. He commented on the significant amount of Board and Committee work that needs to be accomplished by year end and suggested the Board may want to continue the discussion from the July retreat relating to agenda items of importance that the Board wants to focus on, versus what issues should be managed differently moving forward.

Mr. Kaminski asked about the scheduling of the Seattle University School of Law follow-up. Mr. Dear said that Woody Brock and a discussion of Investment Beliefs filled the October Board agenda and suggested that the follow-up could be scheduled for November or December. Members expressed a desire to wrap-up the matter and suggested placing the topic on the November agenda. Mr. Dear said that staff would discuss the scheduling with the Seattle University faculty and plan accordingly.

OTHER ITEMS

There was no further business to come before the Board. The meeting adjourned at 2:25 p.m.

Pat McElligott
Chair

ATTEST

Joseph A. Dear
Executive Director