

WASHINGTON STATE INVESTMENT BOARD
Board Meeting Minutes
October 19, 2006

The Washington State Investment Board met in open public session at 9:35 a.m. in the boardroom at 2100 Evergreen Park Drive SW, Olympia, Washington.

Present: Pat McElligott, Chair
Glenn Gorton, Vice Chair (via teleconference)
Charlie Kaminski
George Masten
Sandy Matheson
Treasurer Mike Murphy
Bob Nakahara
David Nierenberg
Mason Petit
Dave Scott
Judy Schurke
Jeff Seely
Representative Helen Sommers

Absent: Senator Lisa Brown
John Magnuson

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

Paul Silver, Assistant Attorney General
Dr. Horace "Woody" Brock, Strategic Economic Decisions
Tom Iannucci, Cortex Applied Research
Laurence Waring, Cortex Applied Research
Valter Viola, Holland Park Risk Management, Inc.

[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.

OATHS OF OFFICE

Chair McElligott administered the oath of office to Judy Schurke, the acting Labor and Industries Director, and to Charlie Kaminski, reappointed as a nonvoting Board member for a term beginning January 1, 2007, until December 31, 2009.

WOODY BROCK PRESENTATION

Dr. Brock gave a presentation covering the state of the residential housing market and potential impacts on the economy if property value growth stagnates or declines, the policy levers available to the Federal Reserve to manage inflation, and supply and demand drivers of commodity prices.

[Vice Chair Gorton was in attendance at 9:44 a.m.]

[Ms. Matheson was no longer in attendance at 10:54 a.m.]

COMMITTEE ASSIGNMENTS

Mr. Scott moved to accept the Chair's recommendation to appoint Mr. Petit and Ms. Schurke to the Public Markets Committee; Mr. Masten seconded and the motion carried unanimously.

ADOPTION OF THE SEPTEMBER 21, 2006, MINUTES

Mr. Masten moved to adopt the September 21, 2006, Board minutes; Mr. Scott seconded and the motion carried unanimously.

PUBLIC COMMENT

There was no public comment.

[The Board recessed at 10:58 a.m. and reconvened in open session at 11:10 a.m.]

[Treasurer Murphy was in attendance at 11:10 a.m.]

INVESTMENT BELIEFS

Mission

Mr. Bruebaker introduced the investment beliefs session, which is a follow-up to a discussion at the June 2006 Board meeting. The June presentation introduced investment beliefs: what they are and why they are important, and also included staff's preliminary thoughts on investment beliefs. That session was meant to pique the Board's interest and set-up next steps. He said that today's agenda is intended to begin a review, discussion, and documentation of Board investment beliefs, and topics to be covered include mission, risk, and private equity investment beliefs. Mr. Bruebaker emphasized that he believes this to be the most important work scheduled for the next year. Future sessions will include asset allocation and performance measurement in December, organizational competencies in February, active management in May, portfolio risk budgeting in June, and corporate governance sometime next fall. The discussion is meant to be interactive and the intent is to collect feedback from the members and draft investment beliefs statements for further discussion and refinement. The Board's investment beliefs should drive the construction of investment portfolios.

Mr. Iannucci said that investment beliefs are increasing becoming an industry best practice. Although still not common, progressive investors are attempting to define and articulate their beliefs. He said that investment beliefs can be difficult to delve into and clarify complex issues, but it is a worthwhile discussion. He said that he would cover investment beliefs on mission, Mr. Viola would cover risk, and Mr. Waring would cover private equity.

Mr. Iannucci said that investment beliefs are fundamental assumptions or principles upon which a program or policies are premised. They explain why assets are managed a certain way, develop over time under successive fiduciaries, and help to facilitate discussion on how to manage a fund. They are the foundation of the entire investment program and drive how the organization's time and effort is spent.

Mr. Iannucci said that mission is the starting point for building a program. He described alternative missions that drive decision makers, which are (1) outperform peers; (2) maximize alpha; (3) maximize benefit security; and (4) maximize returns at a prudent level of risk. He reviewed guidance provided by WSIB statutes: RCW 43.33A.110, 140(1) and (2) and discussed how alternative investment beliefs do not have basis when compared to these statutes.

Treasurer Murphy pointed out that, while the Board is not driven by it, peer comparisons are used extensively in the media. Mr. Masten noted that different rules apply to some funds under WSIB's management. Mr. Bruebaker said the focus in this phase of the discussion is on defined benefit plan assets. Mr. Nierenberg said that peer comparison is important to the WSIB for best in class analyses.

Mr. Nakahara commented that missions and beliefs are long term. As a CFO, he is concerned about liquidity and asked how best to balance the long term against the liquidity requirements of current benefits. Treasurer Murphy said that maturation of the funds has a direct correlation to liquidity, noting the closed status of the TRS, PERS and LEOFF plans.

Mr. Bruebaker said that all of the alternative missions are interesting comparisons for discussion but that the focus should be on the primary mission. Treasurer Murphy said that he disagreed with the statement that peer comparisons are not important. Mr. Nierenberg commented that, under the hierarchy of beliefs, maximizing returns at a prudent level of risk is the top priority, but the alternative missions are also important. The majority of members present either strongly agreed or agreed that comparing funds is relevant, although members had some difficulty with how the posed question was worded within Cortex's presentation. The majority of members strongly agreed that pursuing alpha is not a simple strategy for achieving the WSIB's mission and also agreed that diversified portfolios will outperform fixed income portfolios over the long-term. Mr. Kaminski noted that this mission belief will need to be reexamined when discussing the L&I portfolio. The Board agreed that its statute adequately describes the Board's mission.

[The Board recessed at 12:09 p.m. and reconvened in open public session at 12:32 p.m.]

[Mr. Seely was no longer in attendance at 12:32 p.m.]

Risk

Mr. Viola introduced himself to Board and briefly reviewed his background and experience in assessing and managing pension plan risks. He said there are key risk belief areas: (1) can risk be defined?; (2) are some risks more important than others?; (3) can/should risk be measured?; and (4) how is risk best managed? He said that risk is about what can happen in the future, not what actually happened in the past; and said that risks can be measured by assessing severity and probable future adverse outcomes.

Mr. Nierenberg asked Mr. Viola to comment on another view on risk shared by a speaker at the Board retreat, which is: the real risk of a pension fund is the risk of ultimate loss and that volatility

is typically used because it is easier to measure. Mr. Viola described two outcomes as measurements for risk: severity and probability. Understanding the risk probability includes a time element. Volatility is another method for measuring risk.

He described four risk areas: (1) underperforming peers “maverick risk;” (2) underperforming the benchmark “active risk;” (3) assets declining or rising too slowly “asset only risk;” and (4) assets rising less than liabilities “surplus at risk.”

Mr. Viola said that there are differing opinions as to whether risk can be measured. He described the value at risk measurement, which is what could be lost over a period of time with a certain frequency. Mr. Viola said this measurement is easier to understand than standard deviation, handles more types of securities, and focuses on bad outcomes. He emphasized that a risk framework is a key input to investment considerations.

Mr. Viola described alternative views on managing risk: the asset-based allocation and the risk-based allocation. He suggested that the risk-based approach supplements the asset-based approach, by applying a risk measurement over time for more consistent management of portfolios and can be lower cost over the long-term than use of the asset-based allocation alone. This risk budgeting approach is more explicit, more frequently measured, and is an early input rather than a late by-product.

Mr. Nierenberg and Treasurer Murphy emphasized that if another fund is outperforming the WSIB, there is interest in determining what that fund does different to determine if there is something to be learned and potentially implemented with the WSIB program.

Mr. Bruebaker said that his hope was that members agreed that risk matters, as staff plans to do more in the risk area. Mr. Nierenberg commented that the risk presentation was very thoughtful, and he is convinced risk budgeting is a smart thing to do as it will lead to better decision-making. Representative Sommers emphasized that return is the WSIB’s primary focus, with risk important but secondary. She agreed that risk does need more attention, but said she would prefer discussions that are more specific, less theoretical.

Chair McElligott directed staff to work on a risk control presentation for future Board presentation. Mr. Dear said that staff’s proposal would be included in the 2007 strategic plan which will be presented in December for the Board’s consideration. Mr. Nakahara requested that staff gather representative examples from other plans that have quantified risk and the measurements used for the Board to examine.

Mr. Masten said that the Board should not take risk in areas where it is not compensated. The Board’s mission is to focus on the return. He reiterated that Washington State had purposefully separated pension benefits from investments, and some risks are not within the Board’s control. Mr. Kaminski commented that not all risk is visible and that visible risk can be measured and managed.

[The Board recessed at 1:51 p.m. and reconvened in open public session at 2:05 p.m. with Treasurer Murphy serving as acting Chair, as Mr. McElligott was no longer in attendance and Vice Chair Gorton was participating via teleconference.]

[Chair McElligott, Representative Sommers, and Mr. Nierenberg were no longer in attendance at 2:05 p.m.]

Private Equity

Mr. Waring summarized his experience and background. He said that private equity investment beliefs can be more difficult to define because they do not fit within the modern portfolio theory (MPT) very well, implementation can be complicated, and there is a limited data set from which to draw information. Mr. Waring identified industry data sources, and mentioned academic studies that have drawn from those sources. He noted that surveys help to identify trends, but emphasized that the past cannot predict the future. Private equity investments take on two primary risks: liquidity and active management.

Mr. Waring listed the private equity beliefs to be investigated: (1) return premium over public markets or compensation for liquidity risk; (2) enhanced diversification; (3) active management or compensation for skill; (4) benchmark returns and expectations; and (5) risks and management.

The Board discussed compensation for skill within private equity. Mr. Waring noted active management theories, specifically noting Bob Litterman's theory identifying five "C's": confidence, correlation, capacity, capital, and cost. After discussing capacity, Mr. Waring responded to Mr. Kaminski's request to summarize the other four C's: confidence-- find and hire skill; correlation-- bringing together uncorrelated managers; capital-- how much money being put to work and whether you can leverage that capital; and cost-- the price, which takes away from return.

A discussion ensued regarding the skill aspect; identifying top quartile managers, continuing to invest in subsequent investment deals with those managers, and concentration issues.

The discussion continued regarding an appropriate benchmark. Mr. Waring said that it is common to use a public markets index such as the S&P 500 or Russell 3000 plus a premium. Private equity indexes also exist. Mr. Waring said that changing expectations and composition, strong capital in-flows, and inter-quartile spread are issues for consideration. A discussion ensued regarding use of a single benchmark.

With regard to management trends and different strategies, Mr. Waring reported that private equity is receiving significant capital flows, so there are many funds searching for general partners (GPs) with proven track records. A resistance to first time funds exists, and a lot of capital is attracted once skilled GPs are discovered. Other risks include the cyclical nature of return. To manage risks, current trends are to go global and try to identify new GPs (the farm team approach). Staff reported that the WSIB is currently directly invested with 72 GPs in over 200 funds. The Board recognized some time ago that there is benefit to diversification.

EXECUTIVE DIRECTOR'S REPORT

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

Mr. Dear asked Board members to provide suggestions on focus topics for 2007. He detailed the agendas for the remaining 2006 Board and Committee meetings, and announced that a second day had been added to the December Private Markets Committee meeting, scheduled for December 7 and 8. Mr. Dear said the extra day is necessary to present the six investment

recommendations and to discuss the real estate plan for 2007. He encouraged all Board members to attend this Committee meeting. Mr. Dear described the draft agendas for the November and December Board meetings, and the proposed format for the December 7-8 Private Markets Committee meeting. He announced that a planning discussion with the private equity consultant is scheduled for December 5 and 6, and Board members are also invited to attend this session. Discussion of the private equity plan for 2007 is scheduled for the January Private Markets Committee meeting.

With regard to the proposed 2007 Board meeting schedule, Mr. Dear said that the January and February Board meetings were set to occur in the evening, in response to a request at the Board retreat to accommodate the legislative members of the Board during session. The Board discussed the number of meetings proposed for the year. Mr. Dear said the proposal is to not have meetings in March and April to further accommodate the legislative members, but that depends on the timing of investment considerations. Board meetings are also not being proposed for August or October.

Treasurer Murphy expressed his displeasure with scheduling lengthy Private Markets Committee meetings and asked if some of the investment considerations could be rescheduled to a later date. Or, alternatively, if the deals could be dealt with at separate Committee meeting dates over a two-week timeframe. Mr. Dear responded that the GPs need to close their deals by set dates and they are not willing to extend those dates for the WSIB. The WSIB would have to pass on the deals, most of which are real estate deals. Mr. Masten emphasized that the Committee has sought to ramp up the real estate allocation. He stated a preference to deal with all matters over the two-day meeting as proposed.

Mr. Dear said that staff is extremely sensitive to the fact that Board members have other important commitments aside from WSIB board work. He suggested that the agenda may be shortened by having Board members do a thorough review of the due diligence materials prior to the meeting and not have that repeated by the GP presenters at the meeting. He noted that this is a situation where the number of deals deprives the Board of focusing on and discussing strategy, an area which staff is trying to engage the Board.

Mr. Masten indicated that neither of the proposed July dates (24th or 31st) worked for his schedule. Treasurer Murphy stated that the proposed July Audit Committee date is not confirmed, and suggested that the scheduled agenda items could be handled at a different meeting.

A discussion ensued regarding the proposed number of meetings for 2007. Some members would like fewer meetings and some would like to have more meetings to ensure adequate time for in-depth discussions. Mr. Kaminski made special note of the Audit Committee's proposed meeting schedule. Treasurer Murphy expressed concern regarding the length of the evening Board meetings in January and February. He and Mr. Masten agreed to try the evening schedule to accommodate the legislative members, but also said that day meetings are preferred and should be reverted to in the event that the evening sessions do not increase member participation. Some members expressed a concern with regard to travel, including evening traffic congestion and commutes from Eastern Washington.

Mr. Dear said that staff would like input on focus topics of greatest interest and importance to Board members. He requested feedback to him or Chair McElligott before the next Board meeting, so that 2007 schedules can be finalized in November. Mr. Dear reiterated that the Chairs set the agendas and will consider all input.

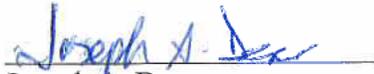
OTHER ITEMS

There was no further business to come before the Board. The meeting adjourned at 3:49 p.m.



Pat McElligott
Chair

ATTEST



Joseph A. Dear
Executive Director