WASHINGTON STATE INVESTMENT BOARD
Board Meeting Minutes
December 21, 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 John Magnuson George Masten Bob Nakahara David Nierenberg (via teleconference) Mason Petit Judy Schurke Representative Helen Sommers
Absent:	Senator Lisa Brown Charlie Kaminski Sandy Matheson Treasurer Mike Murphy Dave Scott Jeff Seely
Also Present:	Joe Dear, Executive Director Gary Bruebaker, Chief Investment Officer Tom Ruggels, Senior Investment Officer – Private Equity Diana Will, Senior Investment Officer – Asset Allocation Janet Kruzel, Investment Officer – Private Equity Kristi Haines, Executive Assistant Paul Silver, Assistant Attorney General Fabrizio Natale, Capital Dynamics

[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.

REAPPOINTMENT OATH OF OFFICE – JOHN MAGNUSON

Chair McElligott administered the oath of office to John Magnuson reappointed as a nonvoting Board member for a term beginning January 1, 2007, until December 31, 2009.

COMMITTEE ASSIGNMENTS

Mr. Masten moved to accept the Chair's recommendation to appoint Senator Brown to the Public Markets Committee and appoint Chair McElligott to the Private Markets Committee. Vice Chair Gorton seconded and the motion carried unanimously.

ADOPTION OF THE NOVEMBER 16, 2006, MINUTES

Vice Chair Gorton moved to adopt the November 16, 2006, Board minutes. Mr. Petit seconded and the motion carried unanimously.

PUBLIC COMMENT

There was no public comment.

PRIVATE MARKETS COMMITTEE REPORT

Private Equity

The Private Markets Committee met on December 7, 2006.

Investment Recommendation – Silver Lake Partners III, L.P.

Mr. Masten moved that the Board accept the Private Markets Committee's recommendation to approve an investment of up to $250 million, plus fees and expenses, in Silver Lake Partners III 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 recommendation is based, in part, on the following: (1) The investment team is strong, with deep technology and operating expertise, an outstanding reputation in the industry, and a powerful extended network of relationships providing a competitive advantage in deal sourcing and value creation post-investment; (2) The firm has a focused, well-defined investment strategy that leverages the team's domain expertise and Silver Lake Partners' (SLP) strong technology franchise; (3) SLP has produced attractive returns since its inception in 1999. In aggregate, SLP has generated a net IRR of 22 percent and a net multiple of 1.5x on $4.7 billion of drawn capital, including $3.2 billion of distributions back to investors; (4) The firm focuses considerable resources on a formalized value creation process post-investment, which includes both strategic and operational initiatives; and (5) This is an opportunity to expand a successful relationship with a high quality, existing general partner.

Mr. Petit questioned whether the company had only realized success due to one investment, and commented that their other investments did not seem quite as good. Mr. Bruebaker said that staff believes that they have matured, and they are the firm to be with in the technology sector. Chair McElligott acknowledged that some of the same concerns were raised and thoroughly discussed at the Private Markets Committee meeting.

The above motion carried unanimously.

Investment Recommendation – TPG STAR, 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 TPG STAR, 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 recommendation is based, in part, on the following: (1) The fund has an opportunistic, differentiated, multi-stage strategy that will invest in venture, growth equity and buyout transactions with equity requirements below $75 million; (2) Texas Pacific Group [TPG] and its affiliates have compiled a solid track record of the types of investments STAR will target; (3) The STAR investment team is strong and experienced, with substantial investment and entrepreneurial experience and deep personal networks, particularly in Asia. The investment team is further enhanced by the deep institutional resources of the global TPG organization, and the participation of TPG Principals David Bonderman, Jim Coulter, and Jonathan Coslet on the STAR Investment Review Committee; (4) The fund is an attractive fit in the private equity portfolio, providing additional exposure to venture capital, growth equity, and middle-market buyout transactions, as well as additional geographic exposure to Asia; and (5) This is an opportunity to deepen a successful relationship with a high quality, existing general partner.

Mr. Bruebaker noted that the performance information shown in the transmittal is not fully attributable to this team, and that this is essentially a first time fund. Staff is familiar with the strategies the firm deploys and the TPG principals are staying involved with the STAR fund. The fund will invest in smaller deals that TPG will no longer be making due to the increase in their fund size. TPG is one of the WSIB's strongest private equity investment partners.

Mr. Nierenberg noted for the record that he would recuse himself from discussion of the TPG STAR investment recommendation due to his firms' relationship with the senior partners of the firm.

> **The above motion carried unanimously.**

Real Estate

Chair McElligott announced that the Board would go into executive session at 9:45 a.m. to discuss financial and commercial information relating to an investment since public knowledge regarding the discussion would result in loss to the funds managed by the WSIB or would result in private loss to the providers of the information. He said the executive session was expected to last until 10:15 a.m. at which time the Board would reconvene in open public session.

[The executive session concluded at 10:42 a.m. and the Board took a brief recess.]
[The Board reconvened in open public session at 10:54 a.m.]

> **Vice Chair Gorton moved that the Board adopt the confidential real estate investment plan for calendar year 2007 that was presented and discussed in executive session, to be used as the guide for the Board and staff as to the types,**

number, size, and overall targets for real estate investments in 2007. Chair McElligott seconded the motion.

Mr. Magnuson said that the plan is very much like last year's, which was followed very tightly. Every proposal brought forward during 2006 tightly correlated to the plan set out at the beginning of the year. The proposed 2007 plan employs different strategies, but he believes that returns will expand and recommendations will fit well into the overall objective of the plan.

The above motion carried unanimously.

ADMINISTRATIVE COMMITTEE REPORT

The Administrative Committee met on December 11, 2006.

Investment Officer Compensation

Chair McElligott reported that the consultant, R.V. Kuhns, presented the findings of their recent investment officer salary survey, conducted at the request of the WSIB. Statute directs investment officer compensation levels to be based on an average salary of state funds of similar size as determined by a biennial salary survey. The Joint Legislative Audit and Review Committee JLARC has reviewed and approved the survey methodology and provided comments on the R.V. Kuhns report. He said that some of R.V. Kuhns' conclusions are: (1) The WSIB has had exceptional investment results; (2) The WSIB is well staffed and allocation of its staff is similar to other funds; (3) Many of the WSIB's investment position salaries are below the average of participating funds; and (4) Fifty-six percent of public funds over $20 billion in size have an incentive bonus program; the WSIB does not.

Chair McElligott said that R.V. Kuhns recommends that the Board consider increasing salaries for those positions falling below the survey average and initiating an incentive bonus program. The report provides average top of salary ranges from which staff has developed proposed salary bands. Salary bands at 28 percent and 41 percent spreads were presented to the Administrative Committee.

Chair McElligott moved that the Board accept the Administrative Committee's recommendation to adopt the new proposed 28 percent salary ranges for Investment Officers to become effective 60 days following the Board meeting, and direct staff to provide 60-day notification of the new ranges to the appropriate parties. Mr. Masten seconded the motion.

Vice Chair Gorton moved to amend the motion to use the 41 percent range as it is more aligned with pay scales used within state agencies. Chair McElligott seconded the motion.

Mr. Magnuson noted that the 41 percent range was what staff originally suggested and a member had asked for the band to be narrowed. Mr. Masten said that both band widths were presented to the Administrative Committee as possible options. Mr. Nierenberg said that within the boards he serves, there is a belief that a linkage exists between performance and compensation and he spoke in favor of the amended motion. Mr. Bruebaker noted the number of investment officer positions by level within the WSIB, not all of which are filled.

The motion to amend the original motion carried unanimously.

The amended motion to adopt the proposed 41 percent salary ranges for Investment Officers to become effective 60 days following the Board meeting, and direct staff to provide 60-day notification of the new ranges to the appropriate parties carried unanimously.

2007 Strategic Plan

Mr. Dear reviewed the framework for the strategic plan including the value chain, the five key drivers, and the value, capacity, and support diagram. He noted that the investment performance benchmarks established in Board policy for each asset class and portfolio define the outcomes for all the projects in the strategic plan.

Mr. Dear said that he hopes that the Board can continue its discussion about what constitutes good board governance at its July meeting. Questions that the Board may want to consider involve developing and institutionalizing best practices, investment beliefs and a risk appetite framework, and to determine how the Board would like to spend its time. He said that a review of the past three years revealed that the Board spent approximately 12 percent of its time on strategic issues, 42 percent on transaction approvals, and the remaining percentage on receiving reports and other administrative issues.

Other 2007 projects include investigating active domestic equity investment strategies; expanding the Enterprise Risk Management framework into investments; and implementing private equity best practices. Within operations, there are plans to build up data, budget, and performance management systems.

Mr. Petit moved that the Board adopt the proposed 2007 Strategic Plan. Vice Chair Gorton seconded and the motion carried unanimously.

Legislative Policy

Chair McElligott reported that a list of issues anticipated for the 2007 Legislative Session was presented at the Administrative Committee meeting. One issue anticipated this session is the introduction of legislation with regard to divesting from companies doing business with Sudan. The WSIB is deeply concerned about the atrocities and human rights violations occurring in Sudan and supports immediate and meaningful action to end the suffering. The WSIB does not, however, believe that can or will be accomplished with legislation forcing the Board to divest or to make any other investment decisions that may not be in the best interests of retirement and other fund beneficiaries. Rather, it believes constructive engagement with portfolio fund managers, companies, regulatory authorities and other institutional investors is the best way to influence positive change and is committed to a program of active engagement to stop the violence and killings in Sudan. The fundamental basis for investment decisions must be what is in the best interests of fund participants and beneficiaries. Decisions based on social or political reasons would violate the Board's fiduciary duty of loyalty to plan participants.

Mr. McElligott moved that the Board accept the Administrative Committee's recommendation to oppose any proposals that would impose mandates or restrictions on the Board's investment and independent decision-making authority. Mr. Masten seconded the motion.

Mr. Nierenberg said that he is in favor of the motion because he believes that, even though the potential legislation may be for a worthy cause, the mission of the Board is to maximize investments for beneficiaries. This could establish a precedent that may be used in ways that the Board does not anticipate or agree with. Secondly, Mr. Nierenberg said that the best way to engage a company is to be a shareholder so that you have an ability to change its board, leadership, strategy, etc. Divestment would disallow the ability to affect change. He suggested that the WSIB continue what is has been doing to date and use its voting rights. Companies do not listen to investors who sell shares. Chair McElligott noted that the issue was heavily discussed at the Administrative Committee and is recommended to the Board by unanimous vote.

The above motion carried unanimously.

Representative Sommers questioned whether the Board had ever passed such a motion in its past. Mr. Dear said that the WSIB had taken positions in the past, but no legislation has ever passed.

Executive Director Evaluation Process

Chair McElligott reported that the Administrative Committee recommends using the same form as last year in evaluating the executive director. He said the forms would be distributed to members for comment, along with a copy of the 2006 strategic plan goals and accomplishments and last year's evaluation of the executive director. Chair McElligott asked members to complete and return the evaluation forms directly to him, and he would compile input for discussion at the January Administrative Committee and Board meetings.

Mr. Nakahara asked to have all documents related to the evaluation forwarded to members electronically. Mr. Nierenberg suggested that members could record a short list of what they would like to see come forward in the year ahead. Chair McElligott said that the evaluation form would be an appropriate method for that input.

STRATEGIC ASSET ALLOCATION

Ms. Will said that the strategic asset allocation would answer two questions raised by the Board at its November meeting. How do returns compare against expected ranges? And, what are WSIB peers doing?

Ms. Will reviewed a series of charts showing expected returns on a one-, three-, and five-year basis using the WSIB's current allocation. Actual past rolling returns have stayed within the expected band ranges 90 percent of the time. She said the bands should provide a good indication of expected returns going forward.

In looking at a peer group for the WSIB, fund size, strategy, return, country, and availability of information was examined. Pension plans at or above $20 billion were determined to be the approximate plans to compare against the WSIB. Size is very important in peer comparisons, as size has a huge impact on what strategies can be effectively deployed, the speed with which changes can be made, and the cost of services purchased. Pension funds, endowments and other types of investment vehicles are managed slightly differently and have varying objectives. The key is to find the best performing fund and understand what is in it and evaluate that against what the WSIB is able to do within its objectives given its size and constraints. The problem is that only past performance can be examined, and that is no guarantee of good performance going forward. Currency conversion and home country bias differentiate international funds from U.S. funds. And, lastly, the availability of information from any fund can be a challenge. Websites may only be updated on a monthly, quarterly, or annual basis and, again, it reflects past performance. Many funds do not release any information.

A peer comparison was done against public and private pension plans with assets under management of $20 billion or more. Corporate pension plans represent a third of the mix while public pension plans represent the remaining two-thirds of the mix. The WSIB's size is about in the middle of the 56 peers. An international peer comparison is slightly skewed due to the scale of the Japanese pension plan of $870 billion. The largest U.S. plan, CalPERS, ranks fifth in size on the international list.

Ms. Will said that a comparison of funds within alternative markets was also examined.
Mr. Nierenberg asked to see more information on the types of hedge funds that WSIB peers are invested in. He said that knowing the types of investing and assets of other funds puts the WSIB in a better position to know what they are trying to accomplish. Ms. Will said that one of the differences between WSIB and its peers is that the peer group has invested in natural resources and real assets; the WSIB has yet to invest in those areas.

Ms. Will said that the WSIB's performance is in the middle of its peer endowments, but their assets look very different. It is also very difficult to get information on endowment investments, but it appears that several have lowered their allocations to private equity. A discussion ensued about how other funds classify investments differently from the WSIB. The Board expressed an interest in learning more about absolute return strategies.

Ms. Will concluded her presentation stating that staff would like to receive guidance from the Board on what else it would like to see so that staff can prepare a private equity allocation recommendation.

[The Board recessed at 12:07 p.m. and reconvened in open session at 12:39 p.m.]
[Mr. Magnuson was no longer in attendance at 12:39 p.m.]

QUARTERLY INVESTMENT PERFORMANCE AND ANALYSIS

Private Equity

Mr. Ruggels introduced Fabrizio Natale from Capital Dynamics' San Francisco office. Mr. Natale provided an overview of the private equity portfolio. He said that the year-to-date authorized commitments were $4.1 billion, significantly more than the $1.5 billion authorized in the first half of 2005. In the second quarter, the portfolio's market value increased by $149.8 million to $9.028 billion. The portfolio appreciated by $427.7 million during the quarter and distributions of $867.1 million exceeded contributions of $589.2 million by $277.9 million.

Mr. Natale reported that the portfolio IRR since inception was just under 15 percent at the quarter-end. The KKR portfolio appreciated by $140.2 million or 6 percent during the quarter, to nearly $2.5 million. The LP portfolio appreciated by $287.5 million or 4.5 percent, to just under $6.6 billion. He said that appreciation was driven primarily by investments in Apax Europe, Nordic Capital, BC Partners, First Reserve, Fortress Group, Charterhouse, and HarbourVest.

During the second quarter, the WSIB authorized seven new investments totaling just over $1 billion and closed on ten commitments totaling nearly $1.8 billion. He said that all subsector allocations except venture capital are within their target ranges. The private equity portfolio has outperformed the benchmark (the S&P 500 total return plus 500 basis points) year-to-date, and on a one-, three-, five-, and ten-year basis. Top performing sectors over the three-year period were corporate finance, international distressed, and direct secondaries. Venture capital has improved recently.

Mr. Natale reported that U.S. buyout and mezzanine fundraising soared in 2006, and is approaching a five-year high. Europe is also experiencing a sharp rise in buyouts and mezzanine. The value of take-private transactions has soared. He reported that seven of the ten largest buyouts of all time occurred in 2006.

EXECUTIVE DIRECTOR'S REPORT
Mr. Dear provided his monthly report for December on Board governance, staff, investments, budget, operations, public affairs, and open procurement activities. Mr. Dear noted a handout of the independent auditor's report on each fund managed by Board. This is the first time an independent audit of financial statements had been performed, and no material issues were raised. Mr. Dear also said that the WSIB had received a letter from the State Auditor reporting that the WSIB had no findings resulting from their annual audit. This is the fifteenth consecutive year the WSIB has received a clean audit. Mr. Dear said that the Governor's budget included the full amount requested by the WSIB.

ETI ANNUAL REPORT
Ms. Kruzel introduced the fourth annual report on the WSIB's Economically Targeted Investment (ETI) policy. The Board approved its ETI policy in 2003, including policy objectives and broad parameters. The WSIB's implementation of the policy remains unique relative to other states. Over the past four years, the WSIB has identified local investors, established solid relationships, and collaborated with organizations, networks, as well as other interested entities and individuals, to foster deal flow in Washington. In 2006, the program continued its focus on regional relationships. WSIB staff has met with nearly 60 firms that are regional or have a regional focus. Any firm raising funds went through due diligence, including review by Capital Dynamics.

Ms. Kruzel said that the WSIB staff is chairing an Institutional Limited Partners Association research project which will collect data on other states' targeted policies and programs and develop a report on industry best practices. Staff will examine the project results for successful and effective practices which could be considered by the Board for inclusion in the WSIB's strategy.

[Mr. Nierenberg was no longer in attendance at 12:54 p.m.]

For the fourth year the WSIB sent letters to its investing general partners (GPs) requesting information on their deal activities within Washington State. Sixty-five responses were received. The data becomes more meaningful each year and shows a persistent presence of the WSIB's GPs reviewing potential Washington-based deals.

Fifty of the responding GPs reported that they considered investment deals in Washington State during the time period October 1, 2005, through September 30, 2006. Twenty of those GPs invested in 51 deals; 41 were new investment deals and ten were add-ons. Thirty-four GPs continue to consider nearly 500 deals in their pipelines. Common responses for why 823 deals not pursued included that the GPs did not feel the deal was ready, the deal was lost to competition, or the opportunity did not fit their strategy. The WSIB has access to top GPs and the survey results verify that they are looking at deals in Washington.

Ms. Kruzel said that deals in Washington and the Northwest region have increased over the past year in both number of deals and dollars invested. There were 3,231 deals in the U.S. that amounted to approximately $23.9 billion. The Northwest attracted about five percent with Washington State taking over four percent of these dollars invested in the U.S. Private equity investments in the WSIB portfolio have increased nearly 43 percent for the 2006 fiscal year over fiscal year 2005. Information technology and healthcare represent approximately 57 percent of those investments in Washington-based companies.

Ms. Kruzel reviewed a chart detailing dollars invested in Washington-based companies which shows that less than four percent of those investments have generated over 58 percent of the distributions received. WSIB investments in Washington State since 1992 have produced a cumulative return multiple of 1.25x.

Ms. Kruzel said that the WSIB will continue to focus on relationships in the coming year and expand its contributions and value added to the regional environment.

OTHER ITEMS

Representative Sommers recognized the quality of staff work, the award-winning chief investment officer, and fine executive director. She acknowledged that the Board's reputation depends on staff work. Chair McElligott thanked staff for their hard work.

There was no further business to come before the Board. The meeting adjourned at 1:18 p.m.

Pat McElligott
Chair

ATTEST

Joseph A. Dear
Joseph A. Dear
Executive Director