WASHINGTON STATE INVESTMENT BOARD
Board Meeting Minutes
February 15, 2007

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

Present:	Pat McElligott, Chair Glenn Gorton, Vice Chair Senator Lisa Brown Charlie Kaminski George Masten Sandy Matheson Treasurer Mike Murphy David Nierenberg Mason Petit Judy Schurke Dave Scott
Absent:	John Magnuson Bob Nakahara Jeff Seely Representative Helen Sommers
Also Present:	Joe Dear, Executive Director Gary Bruebaker, Chief Investment Officer Liz Mendizabal, Public Affairs Director Theresa Whitmarsh, Chief Operating Officer Steve Draper, Senior Investment Officer – Real Estate Tom Ruggels, Senior Investment Officer – Private Equity Nancy Calkins, Senior Investment Officer – Public Equity Diana Will, Senior Investment Officer – Asset Allocation Kristi Haines, Executive Assistant
	Paul Silver, Assistant Attorney General Heidi Miller, JP Morgan Chase (via teleconference) Mike Clark, JP Morgan Chase John Galante, JP Morgan Chase Sandi O'Conner, JP Morgan Chase David Woolford, Capital Dynamics Michael Humphrey, Courtland Partners Joe Cook, Courtland Partners Dr. Horace "Woody" Brock, Strategic Economic Decisions

[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.

PUBLIC COMMENT

Vincent DeBaggis, State Street Bank (SSB), said that SSB has been proud to serve the WSIB for the past ten years as its custodian and securities lending agent and values the relationship. He announced that SSB would like to present an alternative offer letter to the WSIB with regard to the custodian services recommendation, which would memorialize commitments in contract. In response to Chair McElligott's question regarding the appropriateness of the SSB offer, Mr. Dear said that the terms of the Request for Proposal (RFP) are clear and another offer cannot be accepted at this time. Mr. DeBaggis thanked the Board for its relationship, said that he respected the RFP process, and was available to answer any questions members may have.

ADOPTION OF THE JANUARY 18, 2007, MINUTES

> **Mr. Masten moved to adopt the January 18, 2007, meeting minutes.**
> **Ms. Matheson seconded and the motion carried unanimously.**

CUSTODY CONTRACT RECOMMENDATION

Treasurer Murphy introduced the custody contract recommendation agenda item. He distributed prepared remarks to members and asked to have these entered into the meeting record and minutes. With reference to RCW 43.33A.130, "the state treasurer may cause any securities in which the state investment board deals to be registered in the name of a nominee without mention of any fiduciary relationship, except that adequate records shall be maintained to identify the actual owner of the security so registered. The securities so registered shall be held in the physical custody of the state treasurer, the Federal Reserve System, the designee of the state treasurer, or at the election of the designee and upon approval of the state treasurer, the Depository Trust Company of New York City or its designees. With respect to the securities, the nominee shall act only upon the order of the state investment board. All rights to the dividends, interest, land sale proceeds from the securities and all voting rights of the securities are vested in the actual owners of the securities, and not in the nominee."

RCW 43.08.015, Cash management duties, reads, in part, " . . . the state treasurer shall take such actions as are necessary to ensure the effective cash management of public funds. This cash management shall include the authority to represent the state in all contractual relationships with financial institutions. The state treasurer may delegate cash management responsibilities to the affected agencies with the concurrence of the office of financial management."

Treasurer Murphy said that, since 1997, he has managed the custody relationship with financial institutions for assets of the state pursuant to RCW 43.33A.130 and RCW 43.08.015 which provides that the state treasurer shall represent the state in all contractual relationships with financial institutions. In January 2000, the treasurer changed the process for selection of the custodian bank. During Treasurer Murphy's predecessor's term, the treasurer had bundled the custody activities of the state treasurer and the WSIB; one bank had the contract to serve both organizations. At the conclusion of the four year contract, however, Treasurer Murphy made a decision to put out an RFP for the treasurer's needs while allowing the WSIB to continue with the same provider. While fulfilling the statutory duty for both agencies, Treasurer Murphy bifurcated the contract to allow this to happen. At the conclusion of the two year extension granted to the WSIB, Treasurer Murphy delegated the authority to manage the RFP process to WSIB staff. That process entails: (1) approval of the RFP by the treasurer; (2) distributing the RFP to interested parties; (3) reviewing and evaluating RFP responses; and, (4) making a recommendation to the Board. Treasurer Murphy said that, at that time, the Board made a recommendation to him and he agreed to sign a contract with the bank selected by the WSIB. That process began in 2000 and is the identical process to be concluded today. Treasurer Murphy announced that he would recuse himself from the Board's vote on their recommendation. He agreed to abide by the Board's recommended action to name a designee as provided by law and sign the contract.

Ms. Whitmarsh presented staff's recommendation for both the global custodian and securities lending services contracts. Staff chose to combine the contracts under one procurement process for administrative convenience and competitive pricing, which is fairly common in the industry. She relayed that the custodian contract is recommended by the Board with the treasurer as signatory, and securities lending services is an investment contract to be signed by the executive director. Ms. Whitmarsh announced that staff recommends to award both contracts to JPMorgan Chase.

Ms. Whitmarsh said that the custodian bank is an important vendor relationship as it touches every aspect of WSIB business. She described key services provided by the custodian bank including custody/accounting, cash management, investment analytics, performance reporting, compliance monitoring, and securities lending. She said that performance reporting and compliance tools are very expensive and it is cost effective to have these services bundled through the custodian bank. WSIB staff gave special focus to these services during the RFP process and is especially pleased that JPMorgan Chase can provide daily performance reporting, which only the leading public pension funds demand. The custodian bank will also provide index comparisons and scrubbed data to be analyzed during asset allocation studies, and will monitor managers for compliance with WSIB policies and guidelines. Mr. Nierenberg stressed the importance of having real time information available from a risk management perspective.

Ms. Whitmarsh described the securities lending services, which is a separate contract. She said that the WSIB has been netting approximately $1 million in securities lending income each month through the custodian bank. The WSIB currently receives a 75/25 split of that income. She reported that market pressures have increased the split and the WSIB will receive 85 percent in the new contract.

Ms. Whitmarsh summarized that JPMorgan Chase is a custodian that can not only provide core services, but can service a global asset manager with active strategies.

Ms. Whitmarsh acknowledged the significant change and work involved in transitioning to a new custodian, and described the evaluation team and their interaction and focus in examining bank services. The team specifically focused on technology and thought leadership. She reviewed the RFP process; number of bids received; scoring criteria, weighting and results; and site visits.

Ms. Whitmarsh detailed JPMorgan Chase's unique client service model, their top-down risk focus, and superior systems and reporting features. She noted that JPMorgan received good marks from references relating to transitions. Ms. Whitmarsh presented the results of a cost benefit analysis on the transition. Cost was estimated at $40,000. Ms. Whitmarsh said that the savings in switching custodian banks well exceeds the transition cost. With regard to securities lending, no significant differences were noted between the top scoring custodian banks and JPMorgan Chase has full indemnification for securities lending. Board members made note of the $6 million in savings over the current contract, which represents savings to plan participants.

JPMorgan Chase executives introduced themselves. Ms. Miller provided an overview of JPMorgan Chase, its various businesses, and their commitment to the operating service business. Assets under management exceed $1 trillion. Mr. Clark reported on the firm's success and its focus on the long term, size of the operating service unit, growth of assets, and money invested within the past few years on technology and in developing the alternative assets group. Mr. Galante detailed data systems, their locations, network redundancies in place, and compliance monitoring efforts. He said their technology is best in class and client focused, with numerous mechanisms in place to communicate and meet clients' needs. Mr. Galante reported that they contract out for some core accounting capabilities and vendors are measured against service level agreements. He described business continuance testing, and reported that, not only was their no interruption to the bank's services on September 11, 2001, but the bank also picked up processing for some of its competitors.

[Ms. Schurke was in attendance at 10:36 a.m.]

Mr. Clark described JPMorgan Chase's implementation approach, the number of transitions performed by the bank last year, and the anticipated timeline for conversion.

In response to Mr. Masten's question regarding protection against mergers and buyouts that could occur with technology vendor contracts, Mr. Galante described that JPMorgan Chase partners with a small sub-set of large vendors. Extensive credit and reference checks are performed and the bank retains control through access to vendor's source code information.

Ms. O'Conner briefly described JPMorgan Chase's securities lending program. She reported that their program expands into 30 countries, and there is a constant focus on developing new markets and products. JPMorgan Chase has a client focus with customizable programming to match client's investment guidelines. Their technology is easy to use, transparent, and simple. Risk management is very strong, with segregated credit risk management operations.

Treasurer Murphy reminded the Board that he would recuse himself from the vote. He introduced Assistant Attorney General Drew Scott, who works on OST contracts and would assist the WSIB in this contract.

> **Mr. Masten moved that the Board recommend to the State Treasurer the awarding of the global custodial contract with a three-year term and two one-year renewals to JP Morgan Chase, and to the executive director the awarding of the securities lending contract to the same bank, subject to**

additional due diligence and successful contract negotiations. Ms. Schurke seconded the motion.

Treasurer Murphy said that OST practice is to not have contracts end during an election year. Chair McElligott noted that this could be avoided by the WSIB initiating an RFP for custodial services either before any contract renewals or after a first renewal.

Mr. Masten commended the staff work on the custodian bank recommendation, and noted that he was particularly pleased that staff who work directly with the custodian bank were involved. He said he strongly supports staff's recommendation.

The above motion carried with Treasurer Murphy recusing himself from the vote.

BOARD DISCUSSION

Chair McElligott announced that the Board would go into executive session at 10:55 a.m. to review and discuss the performance of Board members and of the Board. He said that he expected the executive session to last until about 11:30 a.m., at which time the Board would reconvene in open session.

[The executive session concluded at 11:45 a.m. and the Board took a brief recess.]
[The Board reconvened in open public session at 11:48 a.m.]

AUDIT COMMITTEE REPORT

Treasurer Murphy reported that the Audit Committee met on January 31, 2007. The WSIB received its fourteenth consecutive clean audit for Fiscal Year 2006 from the State Auditor's Office. Peterson Sullivan presented the results of the first independent audit of WSIB financial statements. Each fund was examined and issued a clean opinion. The auditor indicated that the WSIB has an excellent internal control structure. Peterson Sullivan also reviewed WSIB's internal controls over financial reporting and, with regard to whether the WSIB should seek voluntary compliance with Sarbanes Oxley Act (SOX) Section 404, recommended two areas in which the WSIB could improve their control structure: (1) private market valuations; and, (2) use of spreadsheets in the preparation of financial statements. The firm suggested that pursuing SOX compliance at this time might be premature given the fact that standards may be changing. Staff will present a plan at the next Audit Committee meeting outlining how they plan to address the two areas of recommendation.

Audit Committee Charter 1.00.130 and Internal Audit Charter 1.00.190 Revisions

Treasurer Murphy said that proposed revisions to the Audit Committee Charter 1.00.130 and the Internal Audit Charter 1.00.190 were discussed. Additions to the Audit Committee Charter include the duties of reviewing the WSIB financial statement audit results, significant adjustments, suggestions for improvements to the financial reporting process, and status of legal matters that may effect the financial statements. The Committee also recommended the addition of the words "and related" to describe the financial oversight provided by the Audit Committee. The Internal Audit Charter update reflects the delegated responsibility of managing contracts for firms hired to perform audit-related services to Internal Audit, making it consistent with the Audit Committee Charter.

Treasurer Murphy moved that the Board accept the Audit Committee's recommendation to approve the proposed revisions to the Audit Committee Charter 1.00.130 and the Internal Audit Charter 1.00.190. Mr. Masten seconded and the motion carried unanimously.

Cash Overlay Program Management

Internal audit presented the Cash Overlay Program Management Report 2007-01, which involved an audit of Russell Implementation Services, Inc. The overall assessment of internal governance, ethics, compliance, risk management, contract services, and internal controls was good. Internal audit recommended that staff take advantage of resources currently available to monitor the contract more efficiently.

Treasurer Murphy moved that the Board accept the Audit Committee's recommendation to approve the Cash Overlay Program Management Audit Report 2007-01. Mr. Scott seconded and the motion carried unanimously.

The Committee received the daily valued funds annual report and an update from staff on its ongoing research into private equity compensation policies.

STRATEGIC ASSET ALLOCATION

Ms. Will reviewed past strategic asset allocation presentations. At the November meeting, volatility, liquidity, and other risks were examined. The Board focused on maverick risk and requested a peer comparison. Since the WSIB has a higher allocation to alternative assets than other public pension plans, consideration was given to the most appropriate universe for comparison purposes. In December, a decision was made to look at what endowment funds are doing within alternative assets, and what should be examined to determine if endowments can be considered peers.

Ms. Will reported that alternative assets within endowments include absolute return, real asset, and real estate strategies along with private equity. She said that today's presentation would focus on what endowments are doing in absolute returns or marketable alternatives, or what is more commonly referred to as hedge funds. She announced that upcoming Public Markets Committee meetings would include in-depth education sessions on these investments types.

Ms. Will said marketable alternatives usually use short selling, derivatives, and leverage strategies. While no industry standard exists, marketable alternative can generally be defined into two categories: absolute return and hedged securities. She described each category, the sectors and strategies they generally fall within, primary skills required, and the return and risk drivers needed for these investments. Mr. Nierenberg said that the classification issue can be tricky and the details of each fund need to be closely examined.

Ms. Will reported that endowment funds do not readily share information on their investments and survey results were studied to see how investments are typically classified. She estimated that as of

June 30, 2005, the average endowment had approximately 21.7 percent of their total portfolio in some type of hedge fund or absolute return strategy. Mr. Nierenberg noted that the allocations within some endowments may be a higher percentage. He said that investment strategies with merit and great managers following those categories are important. The WSIB should identify managers with a fabulous record, find out what they are doing, and determine if it is an appropriate strategy for the WSIB portfolio. He said he believed that short selling is a good, legitimate discipline that is worth exploring, and asked how the Board feels about activist funds. He emphasized that the Board should examine investment disciplines and focuses, and firms with excellent track records.

Ms. Will said that staff would like direction from the Board on where to go from here. Her focus is from the asset allocation view versus active management, and the question is whether or not to increase the allocation level of private equity. Ms. Matheson said that the federal government is exploring hedge funds and she would like staff to track that activity. Treasurer Murphy stated that he agreed with Mr. Nierenberg in that staff should work with a reliable fund manager and look at individual track records. Mr. Nierenberg emphasized that the focus should be on strategies that work and managers that make money. Mr. Masten said that it is still unclear how much endowments are allocating to hedge funds, and he likes the strategy Mr. Nierenberg suggested. He added that Board investment guidelines are needed and, perhaps, the allocation amount should be added to the Innovation Portfolio. He stressed the importance of staff reporting their activities in this area. Mr. Bruebaker encouraged members to attend the Public Markets Committee's education sessions and said that staff would bring an in-depth asset allocation discussion to the July retreat.

[Senator Brown was no longer in attendance at 12:28 p.m.]
[The Board recessed at 12:28 p.m. and reconvened in open session at 12:54 p.m.]
[Treasurer Murphy was no longer in attendance at 12:54 p.m.]

PRIVATE MARKETS COMMITTEE REPORT
The Private Markets Committee met on February 9, 2007.

Private Equity

Providence Equity Partners VI, 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 Providence Equity Partners VI, L.P., subject to continued due diligence and final negotiation of terms and conditions.**
> **Vice Chair Gorton seconded the motion.**

Mr. Masten said that, if approved, Providence would be a new general partner relationship for the Board. He said that the recommendation is based, in part, on the following: (1) The investment team is experienced, strong, and cohesive, with deep domain expertise, an outstanding reputation, and powerful networks of industry relationships; (2) Providence has developed a leading franchise in its targeted sectors, giving the firm a competitive advantage in generating proprietary deal flow, recruiting top management talent, and gaining access to target sector club deals; (3) The firm's thematic, sector-focused strategy has proven successful through multiple economic cycles and periods of extreme volatility in its target sectors; (4) Providence has achieved one of the best long-term track records in the industry, generating an aggregate net IRR of 38 percent, and a net multiple of 1.5x since 1991 across five previous buyout funds; and, (5) This is an opportunity to establish a new relationship with a top-quality general partner.

The above motion carried unanimously

Affinity Asia Pacific Fund III, 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 Affinity Asia Pacific Fund III, L.P., subject to continued due diligence and final negotiation of terms and conditions. Mr. Petit seconded the motion.

Mr. Masten said that, if approved, Affinity would be a new general partner relationship for the Board. He said that the recommendation is based, in part, on the following: (1) Affinity was one of the early successful control buyout firms in the region and has been a pioneer and innovator in Asian private equity. The firm, under the leadership of Chairman KY Tang, enjoys a strong reputation in the marketplace; (2) Affinity's experienced management team consists of the original six partners who spun out of the private equity arm of UBS AG in 2002. The partners are all Asian locals who have been investing together for an average of 7 years and have 61 years of collective private equity experience; (3) The firm's 7-year track record has proven its ability to add value and then fully realize medium to large buyouts in Asia, a historically challenging region for exits. Fund I has produced a 2.2x net multiple of cost and a 20 percent net IRR on ten investments to date. Fund II is extremely young and unrealized but performing well; and, (4) The opportunity would provide meaningful exposure to the Asia-Pacific region, an area that is under represented in the private equity portfolio, with little overlap of other general partner strategies.

The above motion carried unanimously

Blackstone Capital Partners V, L.P. (Supplemental)

Mr. Masten moved that the Board accept the Private Markets Committee's recommendation to approve an additional investment of up to $200 million, plus fees and expenses, in Blackstone Capital Partners V, L.P., subject to continued due diligence and final negotiation of terms and conditions. Ms. Matheson seconded the motion.

Mr. Masten reported that the recommended investment is in addition to the $200 million the Board previously committed to this fund in 2006. The opportunity to invest additional capital results from Blackstone's decision to "re-open" the fund to seek up to $5.75 billion of additional limited partner commitments. He said that the recommendation is based, in part, on the following: (1) Blackstone is one of the largest and most successful private equity investors in the world, with a very strong franchise in the U.S. and Europe; they are extending their reach into Asia as well. Blackstone's reputation, extensive resources, and vast network of relationships provide significant advantages in deal sourcing, transaction execution, and access to human capital; (2) The management team is deep and experienced with 77 professionals in New York, London, and Mumbai. The 16 Senior Managing Directors have an average tenure of 9 years with the firm; (3) The firm has an exceptional long-term record of performance. Since 1987, Blackstone has drawn $16.3 billion of capital, generating an aggregate net IRR of 22 percent and a net multiple of 1.6x, including $14.4 billion in distributions; and, (4) This is an opportunity to expand a relationship with a high-quality investment partner.

The above motion carried unanimously.

Real Estate

Emerging Beachfront Land Investment Fund, L.P.

Mr. Masten moved that the Board accept the Private Markets Committee's recommendation to approve an investment of up to $50 million, plus fees and expenses, in Emerging Beachfront Land Investment Fund, L.P., subject to continued due diligence and final negotiation of terms and conditions. Ms. Matheson seconded the motion.

Mr. Masten reported that the recommendation is based, in part, on the following: (1) The fund's strategy is to buy oceanfront property in the path of growth, primarily in Asia; (2) They do not plan to develop any buildings—only buy and hold land to sell later to developers; (3) Asia is poised for remarkable growth in tourism over the next decade as the middle class rapidly expands throughout the region. This fund will take advantage of being on the leading edge of this demographic trend; (4) Each of the three primary principals of the fund possess a key skill set important to the venture. They all have considerable experience in Asia in their respective disciplines. Together, this group forms a strong core that possesses the ability to execute this strategy; (5) This team has very high quality underwriting procedures. This will help mitigate some of the relatively high risk factors associated with the fund; and, (6) This is an opportunity for the WSIB to participate in a strategy with the potential for high returns.

The above motion carried unanimously.

GMS International, LLC

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

Mr. Masten reported that the recommendation is based, in part, on the following: (1) The deal was approved by the Board in June 2006; (2) Prior to closing, the company's CEO, Bill Gerrity resigned to pursue other interests; (3) The company's Chief Operating Officer, Steve Bowers, has been appointed CEO; (4) Staff felt that it was appropriate to ask the Committee and Board to re-affirm the previously-approved commitment given this change in management; (5) The company's strategy of investing in necessity retail properties is still sound; (6) They will continue to focus on the western U.S. and Mexico as their target markets. China will not be a near-term market, as this is what Bill Gerrity was working on prior to his resignation; (7) GMS has produced a from-inception net IRR of 29.5 percent as of December 31, 2006, although the return going forward will be lower but still attractive on a risk adjusted basis; (8) The company's current portfolio of 17 shopping centers in California, Washington, Oregon, and Colorado is very high quality and the type of property the WSIB should own long term; and, (9) WSIB will have excellent governance rights, including the ability to remove the Managing Member with or without cause at any time.

The above motion carried unanimously.

Global Co-Investment, LLC

Mr. Masten moved that the Board accept the Private Markets Committee's recommendation to approve an investment of up to $500 million, plus fees and expenses, in Global Co-Investment, LLC (GCI), subject to continued due diligence and final negotiation of terms and conditions. Vice Chair Gorton seconded the motion.

Mr. Masten reported that the recommendation is based, in part, on the following: (1) During the December Private Markets Committee and Board Meeting discussions of the 2007 Real Estate Annual Plan, staff highlighted the goal of expanding existing successful relationships. Follow-on commitments and strategy expansion were mentioned as means of achieving this goal. Co-investment provides another mode of expanding relationships, through committing additional equity to transactions that may otherwise be partly capitalized by investors other than the WSIB; (2) GCI will provide a valuable diversification tool for the real estate portfolio. The program will allow concentration of additional capital in geographies or property types which are deemed attractive on a risk-adjusted basis or are unintentionally underweighted in the portfolio; and, (3) Co-investment is increasingly prevalent in the industry and may provide a considerable growth opportunity for the real estate portfolio going forward.

The above motion carried unanimously.

PUBLIC MARKETS COMMITTEE REPORT

Mr. Scott reported that the Public Markets Committee met on February 6, 2007, to hear annual reviews of the fixed income portfolio and Horizon Funds, consider international equity developed managers' contract amendments, discuss life cycle funds for defined contribution plans, defer the securities lending contract recommendation to the Board, and receive an education session on active and passive equity options in the U.S. equity portfolio. He said that all members are encouraged to attend upcoming education sessions at the April, May, and June Public Markets Committee meetings.

Contract Amendments – International Equity Developed Managers

Mr. Scott moved that the Board accept the Public Markets Committee's recommendation to authorize the executive director to (1) extend the

contracts of Arrowstreet Capital, LP; Barclays Global Investors, N.A.; Capital Guardian Trust Company; Pyramis Global Advisors Trust Company; and William Blair and Company to expire June 30, 2009; and, (2) increase each of the international equity developed markets managers' contracts expenditure ceilings to the total contract amounts depicted in the table below. Mr. Petit seconded the motion.

Contract Name	Contract Number	Total Contract Amount ($ in Millions)
Arrowstreet Capital, LP	04-006	$20.70
Barclays Global Investors, N.A.	04-013	$18.20
Capital Guardian Trust Company	04-004	$20.30
Goldman Sachs Investment Company	04-014	$22.10
Julius Baer Investment Management	04-024	$24.80
LSV Asset Management	04-027	$21.80
Mondrian Investment Partners	04-023	$20.70
Pyramis Global Advisors Trust Company	04-005	$15.40
William Blair and Company	04-025	$21.50

Mr. Scott said that the contract ceiling increase was necessary due to good performance and the increased allocation to international equities from 15 to 23 percent. Assets under management have grown but fee structures have not changed.

The above motion carried unanimously.

Life Cycle Funds Discussion

Mr. Scott moved that the Board accept the Public Markets Committee's recommendation to approve the commencement of a competitive process in concert with Department of Retirement Systems to evaluate and potentially replace the Horizon Funds with retirement target date funds.
Chair McElligott seconded the motion.

Mr. Scott reported that professionally managed retirement target date funds would address the challenges facing defined contribution investors and are better options than the Horizon Funds. Fund benefits include appropriate risk levels for every age, easier understanding by participants, and placing asset allocation and rebalancing decisions with investment professionals.

The above motion carried unanimously.

ANNUAL REPORT

Mr. Dear introduced the twenty-fifth annual report produced by the agency. He said that the report is routinely provided to the Board and stakeholders, and has also been posted to the WSIB's website in recent years. The report is developed entirely in house, except for the printing. Mr. Dear said that policy requires that the Board approve the annual report.

Vice Chair Gorton moved that the Board approve the annual report for Fiscal Year 2006. Mr. Scott seconded and the motion carried unanimously.

COMMITTEE ASSIGNMENTS

Chair McElligott announced that future succession issues at the treasurer's office have caused Treasurer Murphy to step down from the Audit Committee and as its Chair. He asked that the Board approve his recommendation to appoint Ms. Matheson as the new chair of the Audit Committee and appoint Mr. Petit as a new Committee member. Chair McElligott thanked Treasurer Murphy for nine years of service with the Audit Committee.

Mr. Masten moved that the Board accept the Chair's recommendation to appoint Ms. Matheson as the Audit Committee Chair and also appoint Mr. Petit to the Committee. Vice Chair Gorton seconded and the motion carried unanimously.

QUARTERLY INVESTMENT PERFORMANCE AND ANALYSIS

WSIB Managed Funds

Mr. Bruebaker introduced the quarterly report on WSIB managed funds for the period ended December 31, 2006. He reviewed capital markets and the yield curve change. The WSIB has a total of $76 billion in assets under management; 77 percent of these assets are in the Commingled Trust Fund (CTF). The Labor and Industries' portfolio totals $11 billion.

Mr. Bruebaker reported on the performance of the CTF. All classes are within their policy ranges. The CTF returned 5.75 percent for the quarter, but underperformed by 41 basis points (bps) on an implementation value added basis. Performance was helped by allocation decisions, but hurt by manager decisions. He shared that the CTF tends to underperform whenever private markets do not outperform public markets. Performance over the longer terms looks good, with the WSIB placing in the 96th percentile for the one- and five-year compared to its counterparts. For the three-year period, WSIB's performance is number one.

U.S. equity was up 7.2 percent for the quarter but underperformed the benchmark by 3 bps; the portfolio outperformed for all periods except the five-year. International equity was 2 bps above its benchmark for the quarter. Longer term performance was hurt due to underweighting in emerging markets. Mr. Bruebaker reported that the Board's decision to increase its allocation to Capital International was timed well, as they are the top performing manager for both the current quarter and the one-year period. Fixed income was down 38 bps for the quarter, hurt by long duration as well as by CTF government securities underperforming the index government securities. For the 10-year period, fixed income outperformed by 30 bps.

Mr. Bruebaker reviewed the performance of the defined contribution plans. It was not a good quarter for the Bond Market Fund, which was down 40 bps for the quarter. Staff is looking at potential changes in the strategy for the fund. The Money Market Fund was down 1 bp. Within the balanced funds, the Total Allocation Portfolio was down 92 bps; it normally outperforms by a good margin but tends to underperform when private equity underperforms public equity. The three Horizon funds are struggling due to the performance of the Bond Fund. The Socially

Balanced Fund struggled for the quarter, but its manager is always in the top three performers for that category and staff continues to believe that performance over the long term will be good. The Active Value Fund, managed by LSV Asset Management, outperformed the benchmark for the quarter by 23 bps. The Active Core Fund, managed by Barclays Global Investors (BGI), underperformed the benchmark by 71 bps. The Growth Company Fund, managed by Fidelity Investments, had extremely good outperformance at 230 bps over the benchmark. For passive U.S. equity funds, the U.S. Stock Market Index underperformed the benchmark by 7 bps; U.S. Stock Fund outperformed the benchmark by 5 bps, U.S. Large Stock underperformed the benchmark by 5 bps, and U.S. Small Stock underperformed the benchmark by 3 bps. BGI manages all the passive funds. Within the international options, active outperformed the benchmark and is up 114 bps while the passive option underperformed the benchmark by 4 bps. State Street Global Advisors manages the international options.

In response to Mr. Nierenberg's question as to whether the WSIB should do anything to protect its gains against the cyclical nature of public equity, Mr. Bruebaker said that he plans to propose adding a real asset class to take some of the profits and put them elsewhere. Staff also plans to recommend the movement of money from public equity to private equity. Mr. Bruebaker added that the WSIB should focus on where it has a strategic competitive advantage and leverage those strengths. An in-depth discussion on these issues is planned for the July retreat. Mr. Nierenberg thanked Mr. Bruebaker and commented that he really liked the answer and he believes this is exactly what the WSIB should do.

Private Equity
Mr. Ruggels introduced Mr. Woolford, Capital Dynamics, to present the private equity performance report for the third quarter 2006. Mr. Woolford reported that the private equity portfolio increased in value by $219.00 million during the quarter, which constituted appreciation of $271.44 million, less an excess of distributions over contributions of $52.4 million. The market value at September 30, 2006, was $9,247.3 million. He said that 70 percent of the portfolio appreciation could be explained by funds managed by five general partners: Fortress Group, Warburg Pincus, GTCR, Charterhouse, and KKR. Three commitments totaling $1,925.2 million closed during the quarter. The portfolio's net IRR since inception was 15 percent as of quarter-end, unchanged from the previous quarter.

Mr. Woolford reported that all subsector allocations are within target ranges except venture capital. He summarized industry allocation level changes over the past year. The private equity portfolio has outperformed its benchmark, the S&P 500 Index plus 500 basis points, year-to-date, and on a one-, three-, five- and ten-year basis. He also reviewed performance by subsector, noting that small/medium corporate finance and international investments have produced the highest returns over the past five-year period. Mr. Woolford reported on the significant growth of the leveraged loan market in the U.S. and Europe, which has resulted in higher leverage levels in buyout transactions. Mr. Nierenberg said that he believed the leveraged loan number to be even larger than reported.

Real Estate
Mr. Draper introduced Mr. Humphrey and Mr. Cook, Courtland Partners, to present the third quarter 2006 real estate performance report.

Mr. Cook described the growth components within the real estate portfolio since the last quarter, which increased from $5.5 to $6.077 billion. As of September 30, 2006, the real estate portfolio represented 10.9 percent of the CTF. A recent survey in *Pensions & Investments* magazine on real estate holdings by defined benefit plans showed that the WSIB is the fifth largest owner of real estate among pension funds. Additionally, Washington State has the highest exposure in the international area.

Mr. Humphrey reported that, in an effort to protect gains, Courtland examined the early 1990s downturn and cash flow statements, which revealed a lack of capital returned and significant write-downs on value. Currently, total real estate contributions over the past four years, when compared to distributions and return of capital, revealed that a lot of capital is coming back into the portfolio. The WSIB turns its portfolio once within a four-year period, which is a good thing to do.

Mr. Cook reported that there was $5.5 billion in unfunded commitments as of September 30, 2006, which increased to $7 billion through December 2006. A majority of that will be spent on value added and opportunistic investments. It was a very strong quarter for the real estate portfolio with gross returns at 5 percent and net returns of 4.6 percent. He said that two-thirds of these returns resulted from foreign investments and strategies. The other third came from northwest office and other property holdings. Mr. Humphrey observed that the one-year income return of 6.1 percent was up in comparison to the three-year return. He said that income goes down as appreciation goes up.

Mr. Cook said that the real estate portfolio had substantially outperformed its NCREIF benchmark over the longer periods and the quarterly outperformance was at five percent. Northwest office and timber holdings contributed to the strong quarter returns. Mr. Humphrey examined what strategies helped the portfolio's performance during the quarter and for the year ended September 30, 2006, specifically international opportunistic, northwest office, and manufactured housing. Cash flow, pricing, cap rates, values, and vacancy rate trends and their impact on the market were discussed.

EXECUTIVE DIRECTOR'S REPORT

Mr. Dear provided his monthly report for February on Board governance, staffing, investments, operations, budget, public affairs, and open procurements. He announced that this year's retreat would again be held at Port Ludlow.

In the legislative area, Mr. Dear reported that Liz Mendizabal, Public Affairs Director, had successfully worked with Representative Moeller and an advocate group on the Sudan divestment issue and reached an agreement to adopt a resolution and avoid the introduction of legislation. A resolution to memorialize the Board's position on this controversial issue is being drafted and will be sent to Board members for review within the next week. Mr. Nierenberg suggested that Mr. Dear share Washington State's experience on the Sudan issue at an upcoming conference at Yale University. Chair McElligott praised Ms. Mendizabal's efforts.

In response to Mr. Masten's question about whether the WSIB had any position on the rainy day reserve fund legislation, Mr. Dear said that no fiscal impact would occur if the WSIB is given investment authority. The Board discussed the cost of managing the Millersylvania Fund and possible constitutional amendments that may arise and be used as a vehicle to remove the fund from the WSIB's authority.

[The Board recessed at 2:13 p.m. and reconvened in open session at 2:22 p.m.]
[Dave Scott and Judy Schurke were no longer in attendance at 2:22 p.m.]

WOODY BROCK PRESENTATION
Dr. Brock gave his semi-annual presentation on the relative power of the U.S., its affect on the economy, the current trend of derivatives, value versus growth stock, money sources for new investment vehicles, and a risk assessment of the U.S. economy.

[Chair McElligott was no longer in attendance at 2:48 p.m.]

OTHER ITEMS
There was no further business to come before the Board. The meeting adjourned at 3:33 p.m.

Pat McElligott
Chair

ATTEST

Joseph A. Dear

Joseph A. Dear
Executive Director