

WASHINGTON STATE INVESTMENT BOARD
Board Meeting Minutes
March 15, 2007

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
Charlie Kaminski
George Masten
Sandy Matheson
Treasurer Mike Murphy
David Nierenberg (via teleconference)
Mason Petit
Judy Schurke
Dave Scott
John Magnuson
Bob Nakahara
Jeff Seely

Absent: Senator Lisa Brown
Representative Helen Sommers

Also Present: Joe Dear, Executive Director
Gary Bruebaker, Chief Investment Officer
Liz Mendizabal, Public Affairs Director
Theresa Whitmarsh, Chief Operating Officer
Beth Vandehey, Risk and Compliance Director
Kristi Haines, Executive Assistant

Jim Moeller, State Representative, 49th Legislative District
Paul Silver, Assistant Attorney General

[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. Ms. Schurke was congratulated on her recent appointment as the Director of the Department of Labor and Industries.

ADOPTION OF THE FEBRUARY 15, 2007, MINUTES

**Vice Chair Gorton moved to adopt the February 15, 2007, meeting minutes.
Treasurer Murphy seconded and the motion carried unanimously.**

PUBLIC COMMENT

There was no public comment.

[Mr. Nierenberg joined the meeting via teleconference at 9:31 a.m.]

EXECUTIVE DIRECTOR'S REPORT

Mr. Dear provided his monthly report for March on Board governance, staffing, investments, operations, budget, public affairs, and open procurements. He invited all members to attend the upcoming Public Markets Committee active equity management education sessions. The next Board meeting is scheduled on May 17 unless business requires adding an April meeting. Mr. Dear announced that the Senate recently confirmed Mr. Gorton, Mr. Scott, and Mr. Petit's Board appointments. Mr. Dear reported that he noticed during his recent trip to KKR European's Advisory Committee meeting in London private equity is the focus of intense media interest in Europe. The general partners (GP) he visited had various viewpoints on the implications of media focus, some believing is a temporary phenomenon while others believe tax law changes affecting the deductibility of interest in highly leveraged transactions may result. All agreed that it is imperative that private equity firms step up their public relations activity to provide more visibility and make the case for the positive economic impacts of private equity investments. Mr. Dear thinks it is inevitable that the issue will spread to the U.S.

Messrs. Nierenberg, Seely, Magnuson, and Kaminski commented on the departure announcement of an Elevation Partners founder. Mr. Dear also recommended that the Board have further discussions on the changes at Elevation Partners during the upcoming executive session later in the Board meeting.

Treasurer Murphy shared his concern regarding a recent interaction with Securities and Exchange Commissioner (SEC) Annette Nazareth at a National Association of State Treasurers meeting. He said she expressed that the SEC is "fearful of" stockholders having a voice in companies they own. Treasurer Murphy said the Treasurers plan to react strongly with their opposition of this viewpoint, and hoped the WSIB would follow suit.

EDUCATION SESSION – ENTERPRISE RISK MANAGEMENT

Ms. Vandehey introduced the Enterprise Risk Management (ERM) education session. Ms. Vandehey referenced the Office of Financial Management (OFM) article included in the Board packet, which provides a great overview of the ERM program. Ms. Vandehey provided a definition of risk to demonstrate that risk is multi-dimensional. While tools and models are an important part of risk management, the starting point is the agency's culture which must be committed to excellence. Ms. Vandehey reviewed a risk framework developed by the Association of Public Pension Fund Auditors (APPFA). She said that the APPFA risk framework is an example of risks a public pension may encounter and provides an overview of common external and internal risks. The primary goal of the ERM team is to create a risk aware culture. The team openly

discusses risk events, including their impact and likelihood of reoccurrence. The ERM program is part of a total risk framework, which includes compliance, legal, and financial aspects. Ms. Vandehey described how risk measurement and reporting is separate from the portfolio risk management function to ensure that staff who measuring risks cannot be influenced by the staff taking risk. This provides absolute segregation of duties and strengthens the risk control structure. The ERM team is comprised of ten line staff from various agency units. The team meets twice monthly to review the risk database system and further develop the program. It has developed risk tools, questionnaires, dashboard reports, and a staff intranet page. ERM helps drive risk management activities through education, tools, research, focus groups, and scorecard projects. The team encourages managers to embed risk management into unit processes.

Ms. Vandehey reported that risk assessments were performed on 25 core agency business processes, and the assessment results were plotted onto a heat map diagram. Ms. Vandehey reviewed the heat map quadrants, which help to report risk on core operational processes. She said it is okay for risks to appear within the high impact quadrant, provided that management understands which areas are high impacts and have planned sufficient resources and controls over those areas. Mr. Seely complimented the heat map, which is a great way to summarize risk questionnaires and categories for an overall view. A discussion ensued on how the likelihood for an event to occur is assessed, staff involved in assessments, and compensating controls. Ms. Vandehey said that questionnaire results are informative however the real benefit comes from the focus group discussions as it provides ongoing risk education. Mr. Nakahara suggested there may be merit in having independent sources, such as state auditors, comment on staff's risk rankings and assessments. Mr. Dear said that was a good suggestion.

A discussion ensued regarding the low impact ranking of business continuance, controls and infrastructure in place, remote access, and testing. Treasurer Murphy said he believes that business continuance should have a high impact ranking.

In response to Mr. Masten's question as to whether policy or procedural changes have resulted from focus group discussions, Ms. Whitmarsh said that many operational changes have been made and most resulted from ERM discussion of the risk database. Ms. Vandehey performed a demonstration of the risk database, which is accessible by all staff. She detailed the other options for anonymously reporting risks both within the agency and through other state programs, such as the State Auditor's Whistleblower Program. Of the 194 risks entered into the database, only four issues have resulted in a full review, or root cause analysis.

Mr. Dear said that the risk and compliance area growth would continue with the addition of an FTE to the risk area and adding a second internal auditor. A major project is planned to begin expanding ERM into investment processes.

Ms. Vandehey described fiduciary, market, strategic, government environment, operational, reputation risks and how the WSIB manages these key risks. Commenting on market risk, Mr. Nierenberg said he thinks the Board may want to consider derivative products.

Ms. Vandehey summarized that the ERM investment is well worth the effort. It has resulted in more efficient processes and open communications across the agency. Mr. Seely said that staff's

database is impressive. In response to Mr. Masten's question, Ms. Vandehey said that the expansion into investment processes would consider staff's risk appetite and perhaps the Board may want to consider a similar program. Mr. Magnuson asked if the Board had access to better outside consulting with strategic planning. Mr. Dear said the Board can access most anyone it would like to pursue. He also responded to Mr. Magnuson's inquiry regarding interaction with government oversight agencies, which includes the SEC, state legislative relationships, and agency oversight by the State Auditor, Department of Information Services, and Office of Financial Management.

Ms. Schurke complimented staff's efforts, acknowledging that the WSIB is the gold standard to which other state agencies are trying to catch up. She said she would like staff to consider risk transfer.

ADMINISTRATIVE COMMITTEE REPORT

Resolution on Sudan Investments

Ms. Mendizabal introduced the proposed resolution, which was developed after several meetings and discussions between WSIB staff, State Representative Jim Moeller, and members of the Sudan Divestment Task Force—a national activist group that supports state legislation mandating shareholder engagement and possible divestment by public pension funds from companies that have certain business ties with the government of Sudan. In lieu of legislation, these discussions led to an agreement that a resolution would provide the best outcome for all concerned. The proposed resolution establishes formal protocols for staff to regularly monitor WSIB's public equity and fixed income portfolios and constructively engage with any companies in which the WSIB is invested that have provided significant revenue or other support to the government of Sudan.

Ms. Mendizabal and Chair McElligott thanked Representative Moeller for his efforts on the issue.

Representative Moeller acknowledged the efforts of Mr. Nierenberg, who impressed upon him that engagement with companies is important and convinced him that legislation was not the path to take. Representative Moeller said the common goal of those involved was not in question; just how to get there. He commended the staff and Board on their willingness to work toward the goal.

Chair McElligott moved that the Board accept the Administrative Committee's recommendation for the WSIB's support of the Resolution to ensure that Washington's pension investments are not used to support business and government activities linked to terrorism and genocide in Sudan. Vice Chair Gorton seconded the motion.

Treasurer Murphy said he was glad to see the connection to genocide within the resolution. He heard that a Canadian company tried to influence positive change in Sudan and was forced out of the country. It appears this proposed resolution does not prevent companies with good intentions in Sudan. Mr. Dear said the Sudan taskforce's research and analysis is impressive; staff will depend on the taskforce for identifying companies of concern. Mr. Nierenberg thanked Representative Moeller for working with staff on the project. He noted only a handful of national leaders have adopted this approach and he is convinced it will work. Mr. Scott commended this compromise because it highlights the Board's responsibility to live up to its fiduciary responsibilities without abdicating its responsibilities as human beings.

The above motion carried unanimously.

Mr. Dear thanked Ms. Mendizabal for her efforts on the Sudan issue.

[The Board recessed at 10:49 a.m. and reconvened in open session at 11:03 a.m.]

Assistant Attorney General's Report

Mr. Silver reported that an additional \$1.1 million was received from WorldCom chief executive officer Bernie Ebbers. The WSIB's share is \$57,694 and no attorney fees will be deducted. The Enron trial date is set for April 16, although there are pending appeals on the ruling that it is a class action case. Three remaining major financial institutions (Credit Suisse Boston, Barclays, and Merrill Lynch) and three individuals (Jeffrey Skilling, Richard Causey, and Mark Koenig) are set for trial. A later trial is also set for three other financial institutions (Toronto Dominion, Royal Bank of Canada, and Royal Bank of Scotland) that have not yet settled.

Treasurer Murphy asked for status of the action against Mr. Lay. Mr. Silver said that Mr. Lay continues to be one of the potential defendants, but it is uncertain whether his estate can be reached because his death occurred prior to consideration of his appeal. Due to this sequence of events, Texas appeals law considers the indictment as though it never happened. Mr. Silver assured Treasurer Murphy that whatever avenues are available to access Mr. Lay's estate would be pursued.

PRIVATE MARKETS COMMITTEE REPORT

The Private Markets Committee met on March 7, 2007.

Private Equity

Apax Europe VII, L.P.

Mr. Masten moved that the Board accept the Private Markets Committee's recommendation to approve an investment of up to €115 million, plus fees and expenses, in Apax Europe VII, L.P., subject to continued due diligence and final negotiation of terms and conditions. Vice Chair Gorton seconded the motion.

Mr. Masten reported that the fund, with a target size of €8.5 billion, will pursue large European buyout transactions in five industry sectors: financial and business services, healthcare, media, retail and consumer, and technology and telecom. He said the recommendation is based, in part, on the following: (1) The Apax team is one of the largest and most experienced in Europe, with 81 investment professionals located in six offices across the region. The partners have worked together an average of nine years; (2) Strong long-term performance. The six funds raised by Apax since 1995 have produced an aggregate 33 percent net IRR and a 1.6x net multiple on €8.0 billion of invested capital; (3) The fund will leverage Apax's strong franchise and global platform to seek transcontinental investment opportunities where the target company may benefit from Apax's presence and network in Europe; and, (4) This is an opportunity to expand a relationship with a long-term, high-quality partner.

The above motion carried unanimously.

Avenue Special Situations Fund V, L.P.

Mr. Masten moved that the Board accept the Private Markets Committee's recommendation to approve an investment of up to \$150 million, plus fees and expenses, in Avenue Special Situations Fund V, L.P., subject to continued due diligence and final negotiation of terms and conditions. Vice Chair Gorton seconded the motion.

Mr. Masten reported that the target size of the fund is \$4.5 billion and will invest primarily in the debt and equity securities of U.S. companies in financial distress. He said the recommendation is based, in part, on the following: (1) Avenue's large management team of 24 investment professionals with 270 years of collective experience; (2) Avenue V will pursue the same top-down, analytically intensive investment strategy successfully deployed by the principals in the four previous Avenue funds; (3) The firm has a solid nine-year track record, producing an aggregate net IRR of 18 percent since 1998, with a loss ratio of just over one percent. Including recycling, the team has invested a total of \$6.4 billion; and (4) The investment will provide meaningful exposure to the distressed subsector, an area that is currently underrepresented in the private equity portfolio.

The above motion carried unanimously.

OCM Opportunities Fund VII and VIIb, L.P.

Mr. Masten moved that the Board accept the Private Markets Committee's recommendation to approve an investment of up to \$300 million to be allocated between OCM Opportunities Fund VII, L.P. and OCM Opportunities Fund VIIb, L.P., plus fees and expenses, subject to continued due diligence and final negotiation of terms and conditions. Vice Chair Gorton seconded the motion.

Mr. Masten reported that the funds will invest primarily in the bonds and bank debt of financially distressed companies in the U.S. and Europe. He said the recommendation is based, in part, on the following: (1) Oaktree has one of the largest, most experienced, and respected distressed debt franchises in the industry. The team has developed an extensive network of contacts through which they receive preferential access to opportunities; (2) Oaktree has proven its ability to add value through strong fundamental analysis, skillful price negotiation, and active participation in the restructuring process through multiple investment cycles; (3) Oaktree has a strong, long-term track record with substantial realizations. Since 1995, the OCM Opportunities funds have produced an aggregate net IRR of 15 percent and a net multiple of 1.5x; and, (4) This investment is a good fit in the portfolio, providing relatively low-risk diversification. The current allocation to distressed debt is at the lower end of the targeted range.

In response to Treasurer Murphy's questions, Mr. Bruebaker said that staff anticipates an investment of at least \$75 million in Fund VII and will maximize whatever opportunity it can get up to the Board approved level.

The above motion carried unanimously.

Real Estate

Morgan Stanley Real Estate Special Situations Fund III, L.P.

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 Morgan Stanley Real Estate Special Situations Fund III, L.P., to be invested over the next 18 months as the fund is re-opened, subject to continued due diligence and final negotiation of terms and conditions. Ms. Schurke seconded the motion.

Mr. Masten said the recommendation is based, in part, on the following: (1) The Morgan Stanley team has successfully invested on behalf of the WSIB since 1996. The deep real estate team has over 700 staff and offices in 21 countries; (2) The fund's strategy is to take non-controlling positions in real estate operating companies (REOCs). Morgan Stanley has demonstrated expertise to generate excellent returns from this approach; (3) WSIB staff monitors these companies in the event that the best of them could potentially graduate in the future to a larger and more direct relationship with the WSIB, fueling the REOC real estate investment strategy; and, (4) The fund is off to a fast start, with investments in more than two dozen companies thus far and a large pipeline of potential deals.

The above motion carried unanimously.

Pacific Properties, S.C.

Mr. Masten moved that the Board accept the Private Markets Committee's recommendation to approve an investment of up to €160 million, plus fees and expenses, in Pacific Properties, S.C., subject to continued due diligence and final negotiation of terms and conditions. Vice Chair Gorton seconded the motion.

Mr. Masten said the recommendation is based, in part, on the following: (1) It is a REOC investment, consistent with the WSIB's primary real estate strategy; (2) It represents an opportunity to participate in creating a dominant franchise in a market with considerable potential; and, (3) Demographic trends point to the possibility of substantial growth in the French Polynesian tourism market in coming years; (4) Chief Executive Officer Dick Bailey is very experienced, connected in the market, and backed by a solid team. The company is also a leader in including environmentally friendly initiatives in their projects. Mr. Bailey will invest a significant amount alongside the WSIB in the company. Staff believes this will create an exceptional alignment of interest; and, (5) This is an opportunity to invest alongside a proven regional player in a strategy with considerable upside potential and a short list of meaningful competitors. This would constitute a first-mover investment.

The above motion carried unanimously.

Emerging Markets Fund-of-Funds, LLC

Mr. Masten moved that the Board accept the Private Markets Committee's recommendation to approve an investment of up to \$400 million, plus fees and expenses, in Emerging Markets Fund-of-Funds, LLC, subject to continued due diligence and final negotiation of terms and conditions and, in addition to this commitment, include the WSIB's prior commitments to Prosperitas Real Estate Fund I (\$50 million), Indochina Land Holdings 2 (\$25 million), and Emerging Beachfront Land Investment Fund (\$50 million) in Emerging Markets Fund-of-Funds, LLC, provided that no more than \$50 million can be invested in any one fund, without Board approval. Vice Chair Gorton seconded the motion.

Mr. Masten said the recommendation is based, in part, on the following: (1) The investment represents an opportunity to identify and take advantage of demographic, economic, and political trends in global emerging markets; (2) A select number of particularly attractive local management teams may be encountered that could be advanced to a more prominent role in the WSIB's real estate portfolio longer term; (3) Some emerging markets funds do not have large institutional investors and require shorter decision timeframes from investors than larger funds. The creation of this fund enables staff to move more nimbly to react to these demands; (4) This investment vehicle provides valuable diversification for the real estate portfolio by adding generally to its positions in emerging markets. By investing in a broad base of funds, it may also provide diversification within emerging markets; and, (5) While generally risky by nature, emerging markets real estate investments can provide attractive risk-adjusted returns. The Committee recommends limiting the amount that could be invested in any one fund within the fund-of-funds to \$50 million. Investments exceeding \$50 million would require approval by the Private Markets Committee and Board. Mr. Masten noted that this proposal differs from the Board packet materials.

Mr. Masten moved to amend the motion to remove "subject to continued due diligence and final negotiation of terms and conditions." Chair McElligott seconded the amended motion.

Mr. Masten said that once final terms and conditions are reached, the chief investment officer and executive director would have final approval. In response to Treasurer Murphy's question regarding the replacement transmittal page 3-4 distributed at the meeting, Mr. Dear said that the page was updated to include Mr. Bruebaker's signature.

The above amended motion that the Board approve an investment of up to \$400 million, plus fees and expenses, in Emerging Markets Fund-of-Funds, LLC and, in addition to this commitment, include the WSIB's prior commitments to Prosperitas Real Estate Fund I (\$50 million), Indochina Land Holdings 2 (\$25 million), and Emerging Beachfront Land Investment Fund (\$50 million) in Emerging Markets Fund-of-Funds, LLC, provided that no more than \$50 million can be invested in any one fund, without Board approval carried unanimously.

Mr. Silver confirmed that Courtland Partners is eligible to bid in a competitive search process. Mr. Dear noted that an investment policy would be brought for Board approval. When asked about capital recycling, Mr. Bruebaker said the fund-of-funds itself will not have the ability to recycle capital, but the underlying fund investments may have these rights.

BOARD DISCUSSION

Chair McElligott announced that the Board would go into executive session at 11:25 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 end at 12:00 p.m., and the Board would adjourn at the conclusion of the executive session.

[Mr. Magnuson and Mr. Seely were no longer in attendance at 11:59 a.m.]
[The executive session concluded at 12:27 p.m.]

OTHER ITEMS

There was no further business to come before the Board. The meeting adjourned at 12:27 p.m.



Pat McElligott
Chair

ATTEST



Joseph A. Dear
Executive Director