WASHINGTON STATE INVESTMENT BOARD
Board Meeting Minutes
September 20, 2007

The Washington State Investment Board met in open public session at 9:31 a.m. in the boardroom at 2100 Evergreen Park Drive SW, Olympia, Washington.

Present:	Pat McElligott, Chair Glenn Gorton, Vice Chair Senator Lisa Brown (via teleconference) Charlie Kaminski John Magnuson George Masten Sandy Matheson Bob Nakahara David Nierenberg Mason Petit Judy Schurke Dave Scott Jeff Seely
Absent:	Treasurer Mike Murphy Representative Helen Sommers
Also Present:	Joe Dear, Executive Director Gary Bruebaker, Chief Investment Officer Nancy Calkins, Senior Investment Officer – Public Equity Steve Draper, Senior Investment Officer – Real Estate Bill Kennett, Senior Investment Officer – Fixed Income Tom Ruggels, Senior Investment Officer – Private Equity Diana Will, Senior Investment Officer – Asset Allocation Steve Lerch, Research Director Kristi Haines, Executive Assistant Brian Buchholz, Assistant Attorney General Paul Silver, Assistant Attorney General Mike Heale, Cost Effectiveness Measurement, Inc. Michael Humphrey, Courtland Partners Urs Rieder, 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.

ADOPTION OF THE JULY 17-19, 2007, MINUTES

Mr. Masten moved to adopt the July 17-19, 2007, meeting minutes. Mr. Scott seconded and the motion carried unanimously.

PUBLIC COMMENT

Marguerite Young and Jeneil Lagasse, representatives of the Service Employees International Union (SEIU), provided public comment. Ms. Lagasse said she is a Public Employees' Retirement System member and has worked for the University of Washington for 17 years. She serves as a member of the SEIU Local 925 executive board and is joined today by several SEIU representatives in the audience to deliver a concern on behalf of all the SEIU local unions. She noted that some union members not in attendance have also sent messages to serve as the voice of system participants. The SEIU is concerned with the effect on employment and services created by significant allocations to alternative investments, particularly private equity. While the SEIU is not opposed to investments that seek higher returns, there is concern regarding hidden costs that could be involved affecting the welfare of Washington State relative to tax collections, employment, and the overall economy. Specifically, the SEIU has made disclosure requests to Kohlberg Kravis Roberts and Company (KKR) relating to their buyouts. Ms. Young relayed that the SEIU had asked KKR to disclose the amount of taxes paid by companies prior to purchase by KKR, compared to taxes paid after the buyout. They further requested information on compensation and benefits before and after buyouts, and information on debt incurred by KKR's portfolio companies. KKR responded that their investments are beneficial to Washington State by creating new jobs and better stability, but no documentation was provided to back-up KKR's assertions. Ms. Young remarked that SEIU member Chris King spoke at the September Private Markets Committee meeting, at which Mr. George Roberts, co-founder of KKR, was present. SEIU does not believe that KKR takes their concerns seriously, and they urge that the WSIB use its power as KKR's longest-standing, largest, and most important investor in asking KKR to provide responses to SEIU's concerns.

PRIVATE MARKETS COMMITTEE REPORT

Mr. Masten reported that the Private Markets Committee met on September 6, 2007.

Private Equity

Investment Recommendation – KKR European Fund III, L.P.

Mr. Masten moved that the Board approve an investment of up to $700 million, plus fees and expenses, in KKR European Fund III, L.P., subject to continued due diligence and final negotiation of terms and conditions.

Mr. Masten said the fund will focus on large management buyouts and growth equity investments in Europe. KKR has been a long-term investment partner of the WSIB. Since 1982, the Board has committed more than $6.6 billion to KKR-sponsored investments.
He said the recommendation is based, in part, on the following: (1) KKR has a deep and experienced team of European executives, representing 13 nationalities. The firm has established a strong reputation in Europe as a leading private equity franchise, having successfully completed many of the largest European buyouts to date; (2) The European team is supported by a large, global investment organization with extensive resources, experience, and

expertise; (3) KKR has had strong, long-term performance. In aggregate, the WSIB has earned a net IRR since inception of 17 percent on its KKR investments through March 31, 2007. The first KKR European Fund (1999 vintage) has a net IRR of 22 percent and a 1.8x net multiple. KKR European Fund II (2005 vintage), although very young, appears to be off to a good start with a 10 percent net IRR and a 1.1x net multiple; (4) KKR's proven investment strategy emphasizes value creation through operational improvements in portfolio companies post-investment; and, (5) This is an opportunity to expand a very successful relationship with a high-quality partner.

Ms. Matheson seconded the motion.

Vice Chair Gorton asked for an update to his request that staff check into concerns raised at the Private Markets Committee meeting. Mr. Dear said that he spoke with Mr. Roberts about SEIU's comments at the Committee meeting. Mr. Roberts felt that KKR had answered the SEIU's inquiries. As a follow-up, Mr. Dear strongly encouraged Mr. Roberts to respond to the concern relating to employment impact. Mr. Dear said that getting the tax information would be difficult to do. He believes that the tax reduction that occurs as a result of adding leverage to a company is a tax policy, rather than a private equity issue. Mr. Dear said that the WSIB will continue to discuss beneficiary concerns with KKR and encourage KKR to respond. Mr. Scott said that it is in the best interest of private equity companies to support their claim that, while some jobs may be lost at first, buyouts create more employment opportunities in the long run.

The above motion passed unanimously.

Investment Recommendation – Warburg Pincus Private Equity X, L.P.

Mr. Masten moved that the Board approve an investment of up to $750 million, plus fees and expenses, in Warburg Pincus Private Equity X, L.P., subject to continued due diligence and final negotiation of terms and conditions.
Ms. Matheson seconded the motion.

Mr. Masten said the fund will invest in a variety of private equity transactions including venture capital, growth capital, buyouts, recapitalizations, and other special situations, primarily in North America, Europe, and Asia. The Board has had a successful relationship with Warburg Pincus since 1994. He said the recommendation is based, in part, on the following: (1) Warburg Pincus is one of the oldest and largest players in the industry, with a 35-year history; (2) The firm has a stable and deep investment team, with 60 partners and 150 investment professionals, the core of which has been working together for an average of 15 years; (3) The firm has a true global presence, with nine investment offices worldwide; (4) The firm has a unique top-down strategy, which allows the fund to invest in venture capital, growth capital, or buyouts across industries and across geographies as the investment environment dictates; (5) The firm has solid long-term performance. Through 11 funds, Warburg Pincus has generated a 19 percent net IRR and 2.1x invested capital as of March 31, 2007; (6) The fund is an attractive fit in the portfolio, providing exposure to large venture capital and Asian investments, which are currently under-represented in the portfolio; and (7) This is an opportunity to expand a very successful relationship with a high-quality partner.

Mr. Kaminski asked whether a larger commitment to Warburg Pincus was in order. Mr. Bruebaker responded that the staff would not support an increase unless the Board identified which other private equity commitment could be reduced. In response to Mr. Petit's question, Mr. Masten affirmed the motion is for $750 million rather than $700 million.

The above motion passed unanimously

Investment Recommendation – Advent Latin American Private Equity Fund IV, L.P.

Mr. Masten moved that the Board approve an investment of up to $25 million, plus fees and expenses, in Advent Latin American Private Equity Fund IV L.P., subject to continued due diligence and final negotiation of terms and conditions. Ms. Matheson seconded motion.

Mr. Masten said the fund will pursue control positions in later-stage businesses in Latin America. If approved, an investment in the fund would create a new relationship with Advent International Corporation. He said the recommendation is based, in part, on the following: (1) Advent is one of the largest and most experienced private equity investors in Latin America; (2) The Latin America team capitalizes on the global Advent brand by sharing specific industry knowledge, as well as best practices between all offices of the firm; (3) The fund will continue Advent's proven investment strategy, focusing on control positions in growth buyouts; (4) Advent has a successful ten-year Latin American track record. The group has invested through several economic and market cycles and produced an aggregate net IRR of 18 percent and net multiple of 1.7x, as of December 31, 2006; and, (5) This fund is an excellent portfolio fit, providing exposure to a new geography and diversification benefits to the private equity portfolio.

The above motion passed unanimously

Investment Recommendation – Avenue Special Situations Fund V, L.P. (Supplemental)

Mr. Masten moved that the Board approve an additional investment of up to $50 million (for a total investment of up to $200 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 Board previously approved an investment of up to $150 million in this fund in March 2007. Due to the recent turmoil in the credit markets, Avenue has decided to raise the cap on the fund to pursue a robust pipeline of distressed transactions opportunistically. This is an opportunity for the Board to gain additional exposure to the distressed debt market through an existing relationship with a high-quality partner.

The above motion passed unanimously

Chair McElligott announced that the Board would go into executive session at 9:50 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 that the executive session is expected to last until about 10:10 a.m., at which time the Board will reconvene in open session.

Private Equity – Annual Plan Update

Real Estate – Annual Plan Update

[The executive session concluded at 10:40 a.m. and the Board took a brief recess.]
[Senator Brown was no longer in attendance at 10:40 a.m.]
[The Board reconvened in open session at 10:58 a.m.]

EXECUTIVE DIRECTOR'S REPORT

Mr. Dear provided his monthly report for September on Board governance, staff, investments, operations, public affairs, and open procurements. Mr. Dear acknowledged Ms. Calkins, who is leaving the WSIB at the end of September after nearly 14 years of dedicated service.

Chair McElligott thanked Ms. Calkins for her service to the WSIB, specifically the help she provided to him as a new Board member.

Mr. Kaminski complimented Mr. Dear on the excellent supplemental report that accompanied the August executive director's report. Mr. Dear said that each asset class section was written by the Senior Investment Officers with help from Mr. Bruebaker. Mr. Kaminski requested to have the author's names included on future write-ups.

RISK PRESENTATION

Mr. Lerch introduced the risk presentation, which is in response to a request at the July Board retreat to further examine how the WSIB can measure and manage risk. He said that an earlier Board presentation of the WSIB's Enterprise Risk Management program laid out six key risks: fiduciary, market, strategic, government environment, operational, and reputation risk.
Mr. Lerch said he would focus on market risk, which is the risk of changes in the market value of the portfolio. Risk can be managed through diversification of assets, managers, geographies, and the understanding of individual investment, asset classes, and the total level of the portfolio.

Mr. Lerch referenced Professor Andrew Lo's July presentation, which included discussion of how and why investors make mistakes through cognitive and behavioral biases. Those biases can include loss aversion, overconfidence, overreaction, and herding. Professor Lo suggested that one must adapt by recognizing when market conditions change.

Mr. Lerch differentiated risk from uncertainty. He said that risk probabilities of an outcome are known, there are quantifiable measures of potential loss and variability in return, and it can often be insured or hedged. Uncertainty is when one does not know the probabilities; it cannot be measured, and cannot be hedged or insured.

Mr. Lerch said that risk can be measured quantitatively or qualitatively. Quantitative risk measurement is based on historic data, such as duration and volatility. Qualitative risk requires judgment, knowledge, experience, and it is where due diligence becomes important. Qualitative risk is measured without hard data but can be gauged as high, medium, or low based on the sense of risk. He provided examples of both quantitative and qualitative risks.

Mr. Lerch emphasized that unacceptable potential outcomes should be considered in determining risk appetite. Risk is based on knowledge of history; uncertainty is when the probabilities are unknown or when something could happen when the risk and measures may no longer be relevant. Addressing uncertainty can be accomplished by determining long-term views on asset classes and their interaction, and recognizing when events occur that might change those views. Data should be monitored to consistently examine risk measures, so that short-term and long-term changes in the market can be distinguished and so that patterns that indicate something is different can be examined. Mr. Lerch said that a lot of data is needed to look at all the variables. He said the data warehouse and overlying risk system being put into place at the WSIB will assist in recognizing such changes.

Mr. Kaminski commented on how technology changes have accelerated an ability to quickly deal with data and the WSIB should keep building the skill set to handle it appropriately. Mr. Nierenberg remarked that increased computing power does not necessarily result in better investment decision making. He believes that the WSIB can manage risk through diversification and selecting great managers in asset classes selected for investment. The WSIB should keep communication lines open with managers to know when changes are happening, exploit opportunities, and follow strategies of the brightest managers. Mr. Nierenberg added that hedging techniques are another method to manage risk.

COST EFFECTIVENESS MEASUREMENT REPORT

Mr. Heale presented his annual analysis of the WSIB's cost effectiveness and performance as compared to peers of similar size. He said that Cost Effectiveness Measurement's (CEM) survey results determined that WSIB's performance is excellent and costs are low. In response to Ms. Matheson's question, Mr. Heale explained that the CEM's database standardizes any differences in cost measurement among most funds. Mr. Bruebaker noted that benchmarks also differ between funds and pointed out that WSIB benchmarks are higher than most of its peers.

Mr. Heale described that the CEM performance database is comprised of 131 U.S. funds with aggregate assets of $2.3 trillion. The WSIB is compared to a custom peer group of similar asset size. Peer names are not disclosed, but the group is comprised of 13 public and 7 corporate funds and is the same group used in past reports with very few exceptions. The CEM analysis focuses on the following key performance measures: (1) policy return; (2) implementation value added; (3) implementation risk; (4) costs; (5) cost effectiveness; and, (6) asset-liability mismatch risk.

The WSIB five-year total returns of 11.2 percent is above the U.S. median of 9.7 percent and peer median of 9.8 percent with only one fund with higher returns than WSIB. Policy return is based on asset class benchmark returns and policy weights. The WSIB five-year policy return is the return that could have been generated by passively investing the policy asset mix. The WSIB's policy return is 10.5 percent above the U.S. median of 9.1 percent and peer median of 9.3 percent. The WSIB is above the median primarily due to its higher weighting in real estate and private equity, and lower weighting in U.S. stock.

Implementation value added (IVA) measures the contribution of active management. The WSIB five-year IVA is 0.8 percent compared to a U.S. median and peer median both at 0.6 percent. Most IVA came from real estate and private equity. Mr. Heale said that private equity is difficult to benchmark and comparisons of value added by private equity are less meaningful. The WSIB's five-year implementation risk of 2.8 percent is above the U.S. median of 1.4 percent.

In response to Mr. Seely's question regarding global funds, Mr. Heale said the CEM database includes 25 European funds and the rest are within the U.S. universe. All funds are looked at for performance comparison; and asset management costs look closer at the peer group. Costs are broken down by investment management costs and oversight, custodial, and other asset related costs. The WSIB's actual costs for 2006 were 37.9 basis points (bps). Those costs would be 58.2 bps if run by peers. A key difference in costs is the difference in implementation style. The WSIB uses less external active management, which is more expensive. Fund of funds versus direct choices are also more expensive. The WSIB saved 7.4 bps relative to its peers due to lower use of external active management.

[Mr. Magnuson was no longer in attendance at 11:54 a.m.]

Mr. Heale said that CEM uses a neutral asset mix to estimate liabilities. The WSIB's five-year liability return of 8.8 percent compares to the U.S. median of 7.4 percent and peer median of 7.2 percent. WSIB assets grew 2.1 percent faster than its marked-to-market liabilities. He said the WSIB portfolio is very sensitive to inflation but its risk level is close to peers and the U.S. median. Mr. Kaminski remarked that the marked-to-market liabilities are extremely volatile and WSIB's top quartile shows that liabilities are going up faster than average.

Ms. Matheson complimented the work CEM does for both the WSIB and Department of Retirement Systems. She commented that CEM is rigorous in how it examines data in a complex environment to give members an independent view that she finds very valuable.

Mr. Kaminski noted the outliers on two of the splatter charts and asked if there is anything the WSIB can learn from those plans to possibly implement in its Innovation Portfolio. Mr. Heale suggested some caution in examination of the outliers but encouraged dialogue with Ontario Teachers' Pension Plan, which he feels is truly a cutting edge program. He noted that some peers with larger allocations to private equity and real estate have similar results, but perhaps lower benchmarks that can skew their ranking. CEM is working with the National Association of State Investment Officers to create a better benchmark for private equity. Mr. Kaminski complimented the voting members of the Board and staff for the outstanding results in the report. Mr. Bruebaker commented on the value of CEM's report and its other services that help the WSIB improve.

CHAIR AND VICE CHAIR ELECTION

Chair McElligott nominated Mr. Gorton as Board Chair. There were no further nominations and Mr. Gorton was elected as Chair by acclamation. Mr. McElligott called for nominations for Vice Chair. Mr. Scott nominated Ms. Matheson. There were no further nominations and Ms. Matheson was elected as Vice Chair by acclamation. Mr. Dear complimented Mr. McElligott on the fine job he has done as Chair over the past two years.

[The Board recessed at 12:16 p.m. and reconvened in open session at 12:44 p.m.]

PUBLIC MARKETS COMMITTEE REPORT

Mr. Scott reported that the Public Markets Committee met on September 11, to hear a presentation from Barclays Global Investors (BGI), the finalist in the index-related products manager search; consider revisions to three policies; discuss the implementation of changes in the equity portfolio; and adopt their 2008 meeting schedule.

Index-Related Products Manager Selection

> **Mr. Scott moved that the Board approve the Public Markets Committee's recommendation to select Barclays Global Investors as the index-related products investment manager for the WSIB, subject to final negotiation of terms, conditions, and fees. Mr. Masten seconded the motion.**

Mr. Scott said that staff and Callan Associates conducted a search for the index-related products manager. Two candidates resulted from the process: BGI and State Street Global Advisors (SSgA). Staff recommended that BGI be retained for this mandate. This is an important strategic relationship for the Board and BGI provides the Board with many value-added strategic services. BGI has done a great job managing the funds the WSIB has entrusted to them, they were the least expensive, have an established process for the WSIB to vote its own proxies, and retaining them would not involve any transition costs. Additionally, having key relationships with both BGI and SSgA, the Board's international index manager, provides the WSIB with many benefits.

> **The above motion carried unanimously.**

MSCI Benchmark Change and Related Policy Revisions

> **Mr. Scott moved that the Board approve the proposed revisions to the Labor and Industries' Insurance Funds Policy 2.20.100 and the Advanced College Tuition Payment Program Policy 2.35.100. Mr. Petit seconded the motion.**

Mr. Scott reported that MSCI is making changes to their index that would obligate the WSIB to choose a different index for international equity portfolios. The Labor and Industries (L&I) and Guaranteed Education Tuition portfolios are affected by this move and staff recommends that the Board take advantage of this opportunity to change indices and move to an index that offers these portfolios broader exposure to emerging markets and small cap. The stakeholders are supportive of this change.

> **The above motion carried unanimously.**

Global Equity Benchmark Review

> **Mr. Scott moved that the Board adopt the Dow Jones Wilshire Global Total Market Index as the global equity benchmark for the global equity component of the Commingled Trust Fund. Mr. McElligott seconded the motion.**

Mr. Scott said that, as a result of discussions regarding global equity at the July Board retreat, staff reviewed global benchmarks which would allow the WSIB to weight the U.S. and international equities in line with the changing global economy. Main areas reviewed included breadth, transparency and methodology, adaptability, and data availability.

Mr. Bruebaker reported that the current allocation is 23 percent U.S. equity and 23 percent international equity and, if approved, the allocations would move from static to dynamic. Staff will develop an implementation plan along with the asset allocation recommendation so everything is taken into consideration. It will create an opportunity to make adjustments to where the portfolio is mismatched.

The above motion carried unanimously.

Public Markets Equity – Retirement Funds Policy 2.10.100

Mr. Scott moved that the Board approve the proposed revisions to the Public Markets Equity – Retirement Funds Policy 2.10.100. Mr. McElligott seconded the motion.

Mr. Scott said that revisions to the Public Markets Equity Retirement Funds Policy are necessary to reflect the Board's adoption of a global equity benchmark. The emerging markets allocation in the policy is also changed to establish a range for the allocation based on the weight of emerging markets in the index rather than a fixed percentage.

The motion carried unanimously.

DEVELOPMENTAL DISABILITIES ENDOWMENT FUND POLICY 2.35.400 REVISION

Ms. Will reported that she presents a portfolio review to the Developmental Disabilities Endowment Fund (DDEF) Board annually. WSIB staff did not believe the DDEF portfolio was on the efficient frontier and recommended a policy change. The DDEF consists of both state and private funds. For every individual private account, a certain amount of public funds are contributed. The fund is comprised of 17 percent in public funds, and the remainder is in private funds. She discussed the DDEF's asset allocation, which has a low volatility on state funds. To ensure preservation of capital with some additional return, Ms. Will asked the DDEF Board if they could take a little more risk and proposed two options. The option DDEF selected is to add an international component to their portfolio, which will change the policy from 14 to 17 percent equities and its 100 percent allocation to U.S. equities would change to 50 percent U.S. and 50 percent international.

Mr. McElligott moved that the Board adopt the recommended changes to the Developmental Disabilities Endowment Trust Fund Policy 2.35.400. Newly-elected Vice Chair Matheson seconded and the motion carried unanimously.

ADMINISTRATIVE COMMITTEE REPORT

The Administrative Committee met just prior to the Board meeting on September 20, 2007.

Agency Request Legislation
Mr. McElligott reported that the Committee discussed possible immunity with some investment decisions. Information given by the assistant attorney general suggested that voting members and staff would be covered by the general statute as all state employees.

> **Mr. McElligott moved that the Board accept the Administrative Committee's recommendation that staff request a formal Attorney General's Opinion on the indemnification protection issue. Mr. Scott seconded and the motion passed unanimously.**

Supplemental Budget Request
Mr. Dear said that staff requested the Board's approval to submit a supplemental budget increase. He said that he believed that the FTEs and budget lined up, but discovered within the second week of the biennium that was not the case. While the budget is developed in the summer the year before the biennium takes affect, the investment officer compensation decision is made later in the year and, as a consequence, the approved budget did not provide for the bow wave effect of salary increases granted in the previous biennium. The supplemental budget proposal addresses that shortfall and three other relatively small items. If approved by the Board, the supplemental budget request will be submitted to the Office of Financial Management, then to the Legislature for consideration in the 2008 session.

> **Mr. McElligott moved that the Board accept the Administrative Committee's recommendation to approve the proposed 2007-2009 supplemental budget request. Mr. Masten seconded and the motion passed unanimously.**

[Mr. McElligott was no longer in attendance at 1:04 p.m.]

Assistant Attorney General's Report
Newly-elected Chair Gorton announced that the Board would go into executive session at 1:04 p.m. to discuss litigation or potential litigation with legal counsel since public knowledge regarding the discussion is likely to result in an adverse legal or financial consequence to the WSIB. He said that the executive session is expected to last until about 1:15 p.m., at which time the Board will reconvene in open session. Mr. Silver said that WSIB staff could remain for the executive session.

[The executive session concluded and the Board reconvened in open session at 1:21 p.m.]

QUARTERLY INVESTMENT PERFORMANCE AND ANALYSIS
Quarterly Discussion of Markets
Mr. Bruebaker announced that staff would provide its quarterly report in a different format, with a focus on the disruption in credit markets since June 2007.

Mr. Bruebaker presented performance information against the implementation value added (IVA) benchmark for the quarter, one-, three-, and five-year periods, which was 154 bps, 328, 291, and 191 bps respectively. IVA accounts for how much manager and allocation decisions help or hurt the portfolio. For the quarter, the portfolio allocation was helped by underweighting in fixed income and overweighting in international and private equity, but was hurt by underweighting in U.S. equity. Manager decisions added 3 bps in fixed income, 132 bps in private equity, 12 bps in real estate; manager decisions within the U.S. and international equities hurt performance.

Mr. Bruebaker said that manager performance helped the portfolio for the one- and three-year periods. For the five-year return, an underweight in fixed income helped, while underweighting in private equity and real estate hurt performance. In response to Ms. Matheson's question, Mr. Bruebaker said the under- or over-weightings are compared to target allocations, and the WSIB outperformed other funds in every time period.

Mr. Nierenberg contended that the WSIB's larger allocations to asset classes that are informationally imperfect and broad stratification of returns are less risky than it appears; the risk comes in being different. In terms of risk of losing money, he believes the WSIB is not exceptionally risky but, rather, very shrewd and prudently implementing its plan.

<u>Fixed Income</u>
Mr. Kennett said he would present information on the problems occurring in the credit market since last spring, how the fixed income portfolios are doing, and what staff sees going forward.

He said that certain sectors within the credit market are stable and some are improving, which started before the Federal Reserve easing. Sub prime mortgage defaults are higher than expected and related securities and mortgages are worth less. This situation is occurring everywhere, including Europe and Asia. Sub prime mortgages spread into commercial paper, which are short-term IOUs. He said that investors have lost faith in collateralized debt obligations.

Mr. Kennett said that risk is being re-priced in the credit markets, with higher risk securities being marked down the most. He said that, while he does not believe the crisis is over, large portfolios are doing well, with the WSIB underweight in high yield and financials. In response to Mr. Nierenberg's question, Mr. Kennett said that staff has invested opportunistically.

[Mr. Nakahara was no longer in attendance at 1:41 p.m.]

Mr. Kennett reported on the L&I funds, which are 80 percent fixed income. He said that the Accident Fund is up 47 bps against the CMI, the Medical Fund is up 4 bps, and the Pension Reserve is up 37 bps.

In response to Mr. Petit's question regarding the dollar falling against the Euro, Mr. Kennett said the decline has amounted to 20 percent since 2002, and staff believes it has more to go. The U.S. consumes much more than it exports.

Mr. Kennett concluded by stating that, even with all the recent credit market activity, the Dow Jones and S&P are only within one to two percent of their all time high.

<u>Public Equity</u>
Ms. Calkins presented information on the increase in the overall market volatility from mid-July through August 31, which has put pressure mostly on quantitative processes and any manager using value criteria to rank stocks. She said the environment began with negative news related to lenders and sub prime mortgages. Hedge funds faced losses in their portfolios with requests for redemptions by investors and highly leveraged hedge funds were forced to sell high quality equity and fixed income. Also, some trading desks sought to take advantage of the situation by implementing "anti-quant" trades by shorting stocks with positive exposure to traditional quantitative investing factors, such as attractive valuations, high quality earning, positive price

momentum, and buying stocks that ranked poorly on those measures. The demand for immediate liquidity created market dislocation in the U.S., which also spread to international markets. Ms. Calkins believes that it is a short-term problem as signals and models are rebounding, which is expected to put equity portfolios back on track.

Real Estate

Mr. Draper reported that he would discuss how the current market disruption has affected the real estate portfolio, including potential problems, as well as the opportunities that have arisen. He said he would also note how the WSIB was prepared for the market situation. He said that Courtland Partners would discuss the general market environment.

The first thing Mr. Draper noted that could impact the portfolio is that borrowing has become more difficult and expensive. This directly impacts partners that use higher leverage on properties they purchase. If the economy enters a recessionary period, rents could be negatively impacted. Mr. Draper said that the WSIB portfolio was prepared for the impact of the current credit disruption due to many of its partners using long-term, fixed-rate debt. He noted a slight easing of cap rates of late; he reminded the Board that a higher cap rate means a lower value, and vice versa.

The WSIB's operating partners have shown discipline over time and, thus, have significant "dry powder" available. Partners are positioned to make good investments as they become available. Mr. Draper said that sub-prime mortgages are gone from the market, which shuts out a strata of U.S. consumers from the traditional housing market. This is good news for owners of apartments and manufactured housing communities as they are more affordable options. Mr. Draper described the large overhang of loans currently held by investment banks. He said WSIB partners will likely seek to invest in newly originated debt as opposed to buying into the overhang. The WSIB is helped by its level of governance (it has some say in what partners do and at what pace) and its diversification. Mr. Draper noted the high-quality staff working with him in the real estate group and noted how important they are to the success of the program. In response to Mr. Kaminski's question, Mr. Draper said that, of the $7.3 billion currently invested, about 37-39 percent is outside the U.S., and roughly half of the unfunded commitments are outside the U.S.

Private Equity

Mr. Ruggels described the credit market issue as it relates to private equity. He said that the leveraged loan market is currently in total disarray, although there have been some improvements lately. He said the WSIB invests in a lot of funds that do leveraged buyouts, which is funded through limited partnerships and by borrowing from banks. The banks have evolved over the past few years by selling the loans rather than holding them on balance sheets. This trend accelerated, driven by the availability of credit, enabling large public to private transactions. The overhang is causing the banks not to loan.

Mr. Ruggels described the private equity cycle using real WSIB data from 1999 through 2006 and the effects created when times are good in 1999, versus when technology and telecommunications imploded in 2000, and the impact of from the events of September 11, 2001, which created two years of negative returns. The WSIB committed only $400 million to private equity in 2002. Returns went positive in 2003 and continued in 2004, when change in the credit market was noticed and leverage levels went up. Very loose credit standards and creative financing emerged.

Mr. Kaminski requested some changes to the displayed chart so that it can display the lapse in time between commitments and drawdowns. Mr. Bruebaker agreed to provide data to Mr. Kaminski.

Mr. Nierenberg commented on timing investments to take advantage of opportunities that could emerge. Mr. Ruggels said that he expects the investment pace to slow and large transactions will be difficult to get into until financial institutions clear their overhang. He expects deals to have higher rates and more restrictions, with a focus on growth and operational improvements. Distributions will also slow.

Mr. Ruggels said that, while past WSIB returns on private equity are not sustainable, the portfolio has been built with downturns in mind. Most of the general partners have gone through multi-cycle experience and have held up well under multiple scenarios. Mr. Ruggels believes that private equity will continue to outperform public equity.

[Mr. Scott was no longer in attendance at 2:54 p.m.]

Private Equity
Mr. Rieder of Capital Dynamics spoke about the current private equity market environment. He said that fundraising continues to be very strong. U.S. buyouts outpaced previous years and, although fundraising for European buyouts declined compared to a year ago, levels remain high. The amounts raised by funds over $1 billion have increased; funds under $1 billion have stabilized. The increase of sophistication in the credit markets facilitates formation of mega funds. Credit markets moved to re-price risk creating a liquidity crisis. Two main drivers for this include the sub prime mortgage loan origination and leveraged lending. Mr. Rieder demonstrated the average debt multiples for buyout acquisitions. He said the banks have committed to financing hundreds of millions of dollars in leveraged buyouts, with more than $300 billion committed but not yet financed. Capital Dynamics believes that financing and loan structures will be more conservative going forward, but it still remains to be seen if this is a short-term market or something more serious. Distributions are expected to slow, but the WSIB is well-prepared for that.

Real Estate
Mr. Humphrey of Courtland Partners shared discussions he participated in at a recent Institution of Fiduciary Education event. Recent downturns were referred to as timely speed bumps. The year-over-year median housing price has dropped for the first time since the depression. In response to Board member questions, Mr. Humphrey estimated that 14-15 percent of all defaulted loans were creatively financed. He said that 2 to 2.5 million foreclosures could occur as a result. He noted that some experts are calling for a 10 to 15 percent decrease in home values nationally.

Mr. Dear said there is a clear definition of sub prime mortgages, which were created for people with lower credit scores, required limited documentation to secure a loan, and a number of iterations on variable interest rates. Mr. Humphrey said the default rate of prime loans is less than 3 percent. He reviewed capitalization rate declines, U.S. net capital flows, vacancy rates, and income versus Treasury yields.

BOARD DISCUSSION
Chair Gorton announced that the Board would go into executive session at 3:19 p.m. to review and discuss the performance of Board members and of the Board. He said the executive session was expected to last until 3:25 p.m., at which time the Board would reconvene in open session.

OTHER ITEMS
There was no further business to come before the Board. The meeting adjourned at 3:29 p.m.

Glenn Gorton
Chair

ATTEST

Joseph A. Dear
Joseph A. Dear
Executive Director