

WASHINGTON STATE INVESTMENT BOARD
Board Meeting Minutes
December 20, 2007

The Washington State Investment Board met in open public session at 9:32 a.m. in the boardroom at 2100 Evergreen Park Drive SW, Olympia, Washington.

Present: Glenn Gorton, Chair
Sandy Matheson, Vice Chair
Senator Lisa Brown (via teleconference)
Charlie Kaminski
John Magnuson
Allan Martin (for Treasurer Mike Murphy)
George Masten
Bob Nakahara
David Nierenberg (via teleconference)
Mason Petit
Judy Schurke
Dave Scott (via teleconference)
Jeff Seely
Representative Helen Sommers

Absent: Patrick McElligott

Also Present: Joe Dear, Executive Director
Gary Bruebaker, Chief Investment Officer
Theresa Whitmarsh, Chief Operating Officer
Diana Will, Senior Investment Officer – Asset Allocation
James Mackison, Technology and Innovations Director
Janet Kruzel, Investment Officer – Private Equity
Kristi Haines, Executive Assistant

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 Gorton called the meeting to order and roll call was taken.

OATHS OF OFFICE

Chair Gorton administered oaths of office to Bob Nakahara and Jeff Seely who are reappointed nonvoting members for new three-year terms effective January 1, 2008, through December 31, 2010.

Chair Gorton acknowledged Dave Scott's service on the Board and on behalf of beneficiaries over the past 4-1/2 years. Mr. Scott leaves the Board effective December 31, 2007.

ADOPTION OF THE NOVEMBER 15, 2007, MINUTES

**Mr. Masten moved to adopt the November 15, 2007, meeting minutes.
Vice Chair Matheson seconded the motion.**

Chair Gorton noted a spelling correction of Mr. Martin's first name on page one of the minutes. On page five, under the Asset Allocation discussion, Mr. Masten said that he "moved" the action, rather than "recommended" it. He noted that other motions within the November 15 minutes are similarly worded. Chair Gorton said the minutes would be modified to remove the word "recommended" from the motions.

The above motion carried unanimously.

PUBLIC COMMENT

There was no public comment.

EXECUTIVE DIRECTOR'S REPORT

Mr. Dear provided his monthly report for December on Board governance, staff, budget, investments, operations, public affairs, open procurements, and meeting activities. He announced that the Superintendent of Public Instruction reappointed Mr. Gorton to another three-year term as the School Employees' Retirement System representative, and appointed Mike Ragan as a new member for a three-year term representing the Teachers' Retirement System effective January 1, 2008, until December 31, 2010. The Governor reappointed Mr. Masten to another three-year term effective January 1, 2008, continuing as a retired member of a state retirement system.

[Representative Sommers arrived at 9:42 a.m.]

An updated 2008 Board and Committee calendar was distributed with the executive director's report, reflecting a date change for the October Special Board meeting and a possible October 2 Private Markets Committee meeting. An additional day is noted for the November Private Markets Committee (November 6-7) for private equity annual planning, but dates may be modified to ensure maximum attendance. Mr. Dear announced that Phil Paroian accepted the Senior Investment Officer – Public Equity position effective February 1, 2008. Sam Green, Investment Officer – Private Equity, accepted a position with Oregon State and will leave the WSIB as of January 14, 2008. The WSIB received support for most of its \$1.5 million supplemental budget request, with the exception of \$125,000 relating to health benefits.

Ms. Matheson said that beneficiary communication is needed prior to implementation of the target date funds program to ensure a successful adoption rate.

Ms. Matheson reported on an article published in the December 19 New York Times on a recent report published by the Pew Charitable Trusts, which includes inaccurate information regarding the funding status of Washington State retirement systems. State Actuary Matt Smith reviewed the Pew report and discovered serious flaws; specifically, in that the report only included

Washington's closed plans and used numbers from 2005, rather than the most current numbers. Mr. Dear said that the Governor's Office and Office of Financial Management (OFM) are working to correct this serious misrepresentation. Mr. Seely and Mr. Magnuson commented that the state's response should be immediate and strong. Representative Sommers said the New York Times should issue a correction. Ms. Matheson said that Washington State plans a coordinated media response. Mr. Dear noted for the record that the WSIB manages the assets of 16 retirement plans, 14 of which are overfunded. The two underfunded plans have a scheduled amortization plan.

2008 STRATEGIC PLAN

Mr. Dear introduced the 2008 Strategic Plan. He said that the concentrated essence of the WSIB's strategy is the pursuit of excellence. The WSIB strengths include excellent performance, a skillful Board, talented staff, good support of oversight agencies, and clear focus. Current concerns include highly uncertain markets; investment officer compensation; and that current staffing, processes, and technology will not be adequate in five years. Mr. Dear said the 2008 Strategic Plan combines both strategic and tactical initiatives.

Mr. Dear reviewed the strategic framework, which balances providing value, obtaining support, and increasing capacity. This framework rests on the foundation of a skillful Board. His presentation covered the strategic and tactical initiatives for each of the three areas, including expected outcomes.

Mr. Nakahara asked whether the data warehouse project would provide quantifiable gains relating to investment performance. Mr. Dear responded that it is difficult to know because the information we expect to gain is currently not available to us. The benefit will be prevention of losses and exposures of risks that are not compensated. Mr. Mackison said that the data warehouse will allow a look at risk across all asset classes and help staff gain understanding of how investments interrelate. Ms. Whitmarsh said the data warehouse will support research currently difficult to complete and research findings would be brought forward to the Board to assist decision-making.

**Chair Gorton moved that the Board approve the 2008 Strategic Plan.
Representative Sommers seconded the motion.**

In response to Mr. Masten's question, Mr. Dear said this is proposed as the Board's Strategic Plan, not staff's. Mr. Masten said he would vote no as he disagreed with certain elements of the Strategic Plan, including the annual private equity and real estate plans and agency request legislation. Mr. Masten said that he believes the continuing discussion to grant staff discretion on investments gives up fiduciary responsibility and he will not support it. Additionally, Mr. Masten said he is opposed to incentive pay and a new compensation plan. He asked to be on record as looking long-term and thinks the Board is heading down the wrong road.

Mr. Dear said the staff discretion issue would involve policy revisions, and is separate from the real estate and private equity annual plans. Both issues are scheduled for discussion at the January Private Markets Committee and Board meetings.

The above motion carried, with Mr. Masten voting no.

[The Board recessed at 10:52 a.m. and reconvened in open session at 11:07 a.m.]

[Mr. Seely departed the meeting at 11:07 a.m.]

PRIVATE MARKETS COMMITTEE REPORT

Mr. Masten reported on the Private Markets Committee meeting of December 6, 2007. He said the Committee discussed one private equity investment recommendation and the Real Estate Annual Plan.

Private Equity

Investment Recommendation – Nordic Capital VII, L.P.

Mr. Masten moved that the Board approve an investment of up to €300 million, plus fees and expenses, in Nordic Capital VII, L.P., subject to continuing due diligence and final negotiation of terms and conditions. Vice Chair Matheson seconded the motion.

Mr. Masten said the fund will invest in sector-diversified, large- and middle-market companies primarily in Sweden, Norway, Finland, and Denmark. The WSIB has invested in four previous Nordic Capital funds, committing approximately U.S. \$50 million to Fund III in 1998, U.S. \$81 million to Fund IV in 2000, €100 million to Fund V in 2002, and €150 million to Fund VI in 2005. He said that the Committee's recommendation is based, in part, on the following: (1) The Nordic Capital team has been very stable with minimal turnover since the firm was founded. The team has a significant amount of industry experience, particularly in healthcare and pharmaceuticals, which gives the firm a competitive advantage in deal evaluation and post-acquisition value creation; (2) The Nordic team has produced excellent returns. Since 1990, the firm has drawn €3.57 billion for investment in 53 investments with a combined net IRR of 53 percent. Of these 53 investments, 36 have been fully realized as of June 30, 2007, generating a gross IRR of 74.4 percent, and a 3.7x gross value multiple on realized investments; (3) Rapidly growing buyout activity in the Nordic region, combined with the principals' tenure, reputation, and extensive industrial contacts, creates strong and attractive deal flow; and, (4) The fund's middle-market and Nordic regional focus is complementary to the WSIB's other non-U.S. investments that focus on larger transactions in other countries.

The above motion carried unanimously.

Mr. Masten reported that the Committee had a great discussion of the Real Estate Annual Plan and also discussed staff delegation for follow-on investments identified in the plan. Action regarding the plan and the staff delegation were tabled until the January Private Markets Committee meeting.

ASSET ALLOCATION IMPLEMENTATION PLAN

Ms. Will introduced policy changes necessary to implement the Board's recent asset allocation decision. The proposed Private Markets Committee Charter 1.00.140 revision adds tangible assets to duties and responsibilities. It gives the Committee authority to approve policy, structure,

and strategy for the tangible assets class. The proposed Delegation of Authority Policy 1.05.100 revision gives the executive director authority to manage the tangible assets class. This authority is exactly the same as with other investments, which provide for items such as contract signing and representing the Board at partnership meetings. The proposed Retirement CTF Asset Allocation Policy 2.10.050 revision contains three material changes, including allocation targets, implementation timelines, and adjustments to the passive benchmark. Ms. Will described the specific asset allocation target revisions and the rationale for re-ordering the assets listing within the policy; the schedule of how fast staff anticipates that targets will be met; and adjustments to the passive policy benchmark to accommodate the creation of the global equity asset class which replaces the separate listing of domestic and international equities. She reported that adoption of a new Tangible Assets Policy will be presented at the January Private Markets Committee and Board meetings.

In response to Mr. Magnuson's question regarding back-testing past benchmarks against the new benchmarks to reveal differences, Ms. Will advised that back-testing would likely show slight differences in weighting of international and domestic equities, but changes would not be substantial. Mr. Magnuson said that back-testing may be more relative as allocation targets are reached.

Mr. Masten moved that the Board approve the asset allocation implementation plan and revisions to the Private Markets Committee Charter 1.00.140, Delegation of Authority Policy 1.05.100, and Retirement CTF Asset Allocation Policy 2.10.050. Mr. Petit seconded and the motion carried unanimously.

ADMINISTRATIVE COMMITTEE REPORT

Chair Gorton reported on the Administrative Committee meeting held just prior to the Board meeting on December 20, 2007.

Agency Request Legislation

Mr. Dear provided an update on agency request legislation relating to investment officer compensation. The Board approved submittal of agency request legislation to revise language in RCW 43.33A.100 to clarify use of the retention pool for performance and incentive pay and use of non-appropriated funds, lift the five percent annual limit on the retention pool, and define the salary survey peer group to include endowments. Mr. Dear sent agency request legislation to the director of OFM to seek approval of the Governor's Office. OFM Director Victor Moore expressed concerns with the incentive pay and use of non-appropriated funds elements of the agency request legislation. Mr. Seely and staff met with Director Moore to discuss concerns and gained his support of the incentive compensation piece. WSIB agreed to use a budgeted, non-appropriated funds process as an alternative to non-appropriated funds. Monies would be placed in an account which uses OFM allotment procedures. This would also subject the WSIB to OFM review and spending would be publicly reported. The compromise resulted in OFM's support of the agency request legislation.

Vice Chair Matheson moved that the Board authorize the executive director to seek legislative sponsorship, negotiate, and further refine language as needed to gain passage of the agency request legislation. Representative Sommers seconded the motion.

Mr. Dear said that the agency request legislation still lifts the five percent limitation and allows us to retain the current survey universe, but was changed to drop use of endowments and non-appropriated funds. Mr. Masten advised that he will vote no, as he has not seen staff turnover to warrant this change and does not want the WSIB to be an outlier compared to how other state agencies are treated. Mr. Nierenberg believes that the market determines the market rate for talent. He said, if the WSIB wants to do a good job for beneficiaries and outperform, widely used benchmarks, prudence dictates that it find the right way to deal with meeting market rates. Mr. Petit repeated a concern expressed at the Administrative Committee that compensation relate to the Board's long-term investment strategy focus.

The above motion carried, with Mr. Masten voting no.

Senator Brown announced she would sponsor the bill in the Senate.

Mr. Dear said staff will meet with proponents of an Iran divestment initiative in January and work constructively with them on a resolution that does not involve legislation. He also said that Treasurer Murphy asked him to draw the Board's attention to a proposal relating to recording executive sessions. Mr. Dear reported that Treasurer Murphy opposes the proposal.

Executive Director Evaluation Process

Chair Gorton said the human resource director recommended a few changes to the executive director evaluation form and process based on industry best practices. The Chair will seek anonymous comment from direct reports of the executive director and Board members, using the same questions for both. Forms will be sent out for completion, with comments due back directly to the Chair by January 7, 2008. Comments will be tabulated and results reported at the January Board meeting.

Chair Gorton moved that the Board complete the revised executive director evaluation form and forward their comments to the Chair by January 7.

Mr. Petit seconded and the motion carried unanimously.

Assistant Attorney General's Report

Mr. Silver provided an update on Enron litigation hearings. A proposed plan to distribute \$7.3 billion in settlements to date was submitted to the court and a preliminary approval hearing occurred last week. Some objections are being worked out. Final approval of the plan is scheduled for February 28. The WSIB will submit a claim for bond losses and has a high likelihood to receive a significant return on losses. Stock-related claim losses will be submitted by managers, with recoveries returned to the commingled funds. An attorney fee request is also under consideration of the court. If there are no appeals, actual distributions are anticipated toward the end of 2008.

AUDIT COMMITTEE REPORT

Ms. Matheson reported on the November 27, 2007, Audit Committee meeting.

Fiscal Year 2007 Independent Auditors' Report

Financial Statements and Management Letter

Ms. Matheson said that Peterson Sullivan PLLC presented their Independent Auditors' Reports and provided an unqualified opinion on all funds reviewed. They noted the good work done by staff, indicating they did not have any adjustments to the financials. They did recommend some improvements to the preparation of investment risk disclosures, which management agreed to implement.

Vice Chair Matheson moved that the Board accept the Audit Committee's recommendation to approve the Fiscal Year 2007 Independent Auditors' Reports. Mr. Petit seconded motion.

In response to Mr. Nierenberg's question regarding the management letter, Mr. Dear said that a recommendation was made and implemented by management related to pricing of fixed income securities. There were no material errors found.

The above motion carried unanimously.

Ms. Matheson said that the Committee received an update on the status of the Fiscal Year 2007-2008 Internal Audit Plan, met new internal audit staff member Michelle Wieberg, and received the Audit Recommendation Status Report. Since the last quarterly status report in September 2007, staff continues the work on the remaining two recommendations and the scheduled completion dates remain unchanged.

The Committee received a report on the WSIB's voting record for the first ten months of the 2007 proxy voting season. Glass Lewis & Co. discussed the upcoming 2008 proxy voting season and highlighted what are expected to be the prominent issues of shareholder concern. They anticipate a continued emphasis on controlling executive compensation and election of directors by a majority vote during the next proxy season.

PUBLIC MARKETS COMMITTEE REPORT

Labor and Industries' Industrial Insurance Consultant Selection

Ms. Schurke reported on the November 27 Public Markets Committee meeting. The Committee considered the selection of Conning Asset Management as the Labor and Industries' Industrial Insurance Consultant for the WSIB. Conning holds the current contract, which expires at the end of this year. She said that, in addition to Conning, one other firm, Strategic Asset Alliance, responded to the request for proposal. The evaluation team, comprised of WSIB investment staff members Bill Kennett, Diana Will, Tom Bosworth, and one of Labor & Industries' actuaries, Mark Mercier, scored the proposals based on organization background, knowledge, and experience; quality of existing relationships and references; and fees. Of the non-fee points awarded, Conning received 80 out of 90 and Strategic Asset Alliance received 51 out of 90. Conning has worked for the WSIB and Labor and Industries for roughly 20 years.

Ms. Schurke moved that the Board select Conning Asset Management as the Labor and Industries' Industrial Insurance Consultant for the WSIB, subject to final negotiation of terms, conditions, and fees. Mr. Masten seconded and the motion carried unanimously.

ECONOMICALLY TARGETED INVESTMENT ANNUAL REPORT

Ms. Kruzel introduced the Economically Targeted Investment (ETI) Annual Report. In 2003, the Board took a thoughtful approach to ETIs by developing a policy which details the program objectives and broad parameters. The primary policy objective is to produce investment return, with the possible collateral objective of assisting the regional economy. Ms. Kruzel reported that policy implementation continues to evolve, but constants are apparent after four years including collaboration and relationship building. During 2007, staff met with Washington networks, sought out regional players, worked with companies and entrepreneurs seeking funding, and served as a resource for local firms. Activities also included serving on regional networks, attending regional forums, and monitoring other states' ETI activities.

Staff continues to track deal flow within Washington and will be working closely with several regional funds expected back to market in 2008. Maturing regional teams are establishing track records that continue to make them more attractive to institutional investors.

Ms. Kruzel is chairing a research project that is studying targeted investment programs, such as regional economic development, minority and women owned businesses, and clean tech to identify global industry best practices. The project results will be made available to the Board this spring.

The WSIB investment portfolio total exposure to Washington-based investments is up 13.3 percent from last year, with increased exposure in the each asset classes. She reported that \$1.44 billion is invested in Washington, which represents over 2 percent of the total Commingled Trust Fund. In contrast, Washington's gross domestic product (GDP) is only 0.6 percent of world GDP, which is the WSIB's investable universe. The WSIB has a consistent Washington-based investment which is growing over time. Specifically, private equity investments total \$105.4 million in Washington-based companies. There are 46 general partners investing in Washington, 42 of which are based outside Washington.

Ms. Kruzel said that the annual poll of general partners was conducted again this year, and there are now five years of data. The poll includes all general partners still within their investment period, if they invest in the U.S. General partners are asked to provide information on how many Washington deals they look at during the year, how many were done, and how many are still in the pipeline. There was a 98 percent response this year; 47 out of 54 general partners polled looked at deals in Washington. Poll results reported that 17 general partners did 41 deals in Washington, and 28 general partners still have deals in the pipeline. The actual results, adjusted for responses received after the written report was prepared, increased to 20 general partners that did 45 deals and 29 general partners still have deals in the pipeline. Ms. Kruzel said that report numbers are understated due to varying reporting practices of the general partners. The significant highlight is that Washington continues to earn the interest of and access to quality general partners.

Mr. Kaminski asked if Pathway had invested in any regional fund WSIB has referred to them. Ms. Kruzel said Polaris is the only investment at this time, but Pathway has met with everyone staff has referred. Mr. Kaminski noted that this is a significant event since no other referrals resulted in a local investment. Pathway has indicated interest in several of the funds and is maintaining long-term contact. Ms. Kruzel follows-up with firms that have been referred and feedback to date indicates that Pathway has given the funds respectful audience and helpful feedback. She added that Capital Dynamics often accompanies her on due diligence visits so that, as a group matures, Capital Dynamics is already acquainted with the group and the WSIB is prepared to look at a direct investment in a timely manner. Ms. Kruzel said she would look into whether Pathway is able to invest in SBIC-backed (small business investment company) funds.

Representative Sommers asked if the Washington geography contributes to the significant Washington-based investments or if it is due to WSIB efforts. Ms. Kruzel said that a little of both applies. WSIB invests with the best general partners, who seek out and find the best deals if they are within their investment strategy. Even though several national firms are not headquartered here, some have small regional offices that become conduits for deal flow. In response to Mr. Magnuson's question, Ms. Kruzel said that WSIB regional general partners include Frazier Healthcare, Endeavour Capital, OVP Venture Partners, and Polaris Venture Partners. Mr. Magnuson asked that future reports highlight the WSIB regional general partners on the listing of all regional firm contacts.

BOARD DISCUSSION

Chair Gorton announced that the Board would go into executive session to review and discuss the performance of Board members and of the Board. He said the executive session was expected to last until 12:17 p.m., at which time the Board would reconvene in open session.

[The Board went into executive session at 12:07 p.m. and reconvened in open session at 12:20 p.m.]

OTHER ITEMS

There was no further business to come before the Board. The meeting adjourned at 12:20 p.m.


Glenn Gorton
Chair

ATTEST


Joseph A. Dear
Executive Director