

WASHINGTON STATE INVESTMENT BOARD
Board Meeting Minutes
April 17, 2008

The Washington State Investment Board met in open public session at 9:37 a.m. in the boardroom at 2100 Evergreen Park Drive SW, Olympia, Washington.

Present: Glenn Gorton, Chair
 Sandy Matheson, Vice Chair
 Senator Lisa Brown
 Charlie Kaminski
 George Masten
 Patrick McElligott
 Treasurer Mike Murphy
 Bob Nakahara
 David Nierenberg
 Mason Petit
 Mike Ragan
 Judy Schurke
 Representative Helen Sommers

Absent: John Magnuson
 Jeff Seely

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
 Diana Will, Senior Investment Officer – Asset Allocation
 Shawna Killman, Internal Auditor
 Phil Paroian, Senior Investment Officer – Public Equity
 Teresa Eckstein, Human Resources Director
 Kristi Haines, Executive Assistant

Paul Silver, Assistant Attorney General

[Names of other individuals attending the meeting are listed in the permanent record.]

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

ADOPTION OF THE FEBRUARY 21, 2008, MINUTES

**Treasurer Murphy moved to adopt the February 21, 2008, meeting minutes.
Mr. Ragan seconded, and the motion carried unanimously.**

PUBLIC COMMENT

Ms. Emily Paulin and Ms. Barbara Johnson, SEIU, introduced themselves. Ms. Paulin said she and the approximate 20 SEIU representatives present at the meeting came to represent its 40,000 members whose pension and investments are managed by the WSIB. Ms. Paulin presented statements from SEIU members (with numerous postcards displayed) who are concerned about investment of retirement funds in the buyout industry due to its harmful practices and effects on the local economy. They are specifically concerned with the state's large investments with Kohlberg Kravis Roberts and Company. The SEIU believes tax loopholes allow KKR to avoid paying their fair tax share, which leads to budget shortfalls. They are concerned with the investment of 25 percent of the WSIB's private equity allocation to KKR, which they believe aims to profit at any cost. As a classified school worker, Ms. Johnson said her biggest concern is that she teaches students social responsibility, while social irresponsibility occurs behind the scenes. She wants WSIB to reconsider its private equity investments.

SEIU invited Board members to a town hall meeting to be held at 2:00 p.m. on May 17 in Federal Way. Chair Gorton encouraged Board members to attend the meeting.

Mr. Nierenberg congratulated SEIU's efforts in bringing corporate governance change at Washington Mutual. He pointed out that the private equity investment in Washington Mutual will help preserve jobs in Washington State, and restore the company to health. He noted that private equity funds employ many different strategies.

Senator Brown applauded SEIU's call for tax fairness and corporate responsibility at both the state and national level. She hopes that SEIU will get on board with the working family tax credit initiative passed by the Legislature this year, which will help equalize the state's tax structure over time. The WSIB spends a lot of time discussing the balance between risk and return, and risk should not always be looked at as bad.

Mr. Masten noted WSIB's exceptional returns over 3-, 5-, and 10-year periods. The WSIB has mitigated the risks it takes. He commented that he would also like to see Congress take action on federal taxes.

Mr. Randy Dorn stressed SEIU's point; that they are not saying there should be no private equity investments, but the WSIB should consciously strive for balance in the portfolio and not get too far one way.

EXECUTIVE DIRECTOR'S REPORT

Mr. Dear provided his monthly report for April on Board governance, staff, investments, operations, public affairs, meetings, and open procurement activities. Mr. Dear thanked Representative Sommers and Senator Brown for their efforts during legislative session with the WSIB's compensation bill and supplemental budget request.

CAPITAL MARKET ASSUMPTIONS

Ms. Will introduced staff's recommendation for 2008 capital market assumptions. She indicated she would attempt to describe what the assumptions are, what they are not, and how they are used.

Ms. Will defined return as an arithmetic mean, a simple average of returns. It is a long-term assumption. She explained how returns are derived. Capital market risk focuses on volatility, or standard deviation. Standard deviations are developed from historical information. Ms. Will said that 68 percent of the time a return comes within 1 standard deviation of the mean. A 5 standard deviation is outside the norm, and is considered a “black swan” event. There has been relatively low volatility over the past 5 years. She described that correlation is how asset classes move in relationship to each other.

Ms. Will described how risk and return work together, and how one should not expect to achieve the projected return, but rather a range around that return over the long-term. She explained how there are low and higher risk investments within each of the asset classes. The WSIB equity portfolio is constructed close to its benchmark, which provides a similar base case for consultants to examine in recommending capital market assumptions. The real estate portfolio is dramatically different than its benchmark, so staff’s recommendation is different than the consultant’s.

Ms. Will reviewed the correlations examples between stocks and bonds, and U.S. and international stocks, and then described where the efficient frontier level exists in examining risk and return. She presented staff’s proposed capital market assumptions and their correlations.

Ms. Will explained, in terms of the asset allocation decision, the one-year median return for the Commingled Trust Fund is projected at 8.68 percent. The Board should not expect to earn that over the one-year time period, but rather look at coming with a range around 8.68; and using a 90 percentage confidence level, the return will be up to 33.1 percent and as low as negative 12 percent.

Ms. Will said that staff uses assumptions for examining the permanent funds; and they are used by the State Actuary and others in modeling work.

Mr. McElligott moved that the Board adopt the 2008 WSIB capital market return, risk, and correlation assumptions as stated in the attached table. Representative Sommers seconded, and the motion carried unanimously.

	Expected Return	Standard Deviation
TIPS	4.75	6.00
Fixed Income	5.25	5.00
Tangible Assets	6.50	8.00
Real Estate	8.00	15.00
Global Equity	8.50	16.75
U.S. Equity	8.50	17.00
International Equity	8.50	18.25
Private Equity	12.50	31.00
Cash	3.50	1.75

Correlation	TIPS	Fixed Income	Tangible Assets	Real Estate	Global Equity	U.S. Equity	Int'l Equity	Private Equity	Cash
TIPS	1.00	0.40	0.35	0.10	0.00	0.00	0.00	0.00	0.25
Fixed Income	0.40	1.00	0.30	0.20	0.20	0.25	0.15	0.15	0.20
Tangible Assets	0.35	0.30	1.00	0.40	0.00	0.00	0.00	0.00	0.20
Real Estate	0.10	0.20	0.40	1.00	0.43	0.45	0.40	0.40	0.15
Global Equity	0.00	0.20	0.00	0.43	1.00	0.80	0.85	0.68	0.00
U.S. Equity	0.00	0.25	0.00	0.45	0.80	1.00	0.70	0.70	0.05
International Equity	0.00	0.15	0.00	0.40	0.85	0.70	1.00	0.65	-0.10
Private Equity	0.00	0.15	0.00	0.40	0.68	0.70	0.65	1.00	0.00
Cash	0.25	0.20	0.20	0.15	0.00	0.05	-0.10	0.00	1.00

ETHICS EDUCATION SESSION

Mr. Silver introduced the Ethics education session and referred to a Compliance Guide included in the Board materials. He said the key topics covered in the Guide are derived from two ethics principles: (1) May not use WSIB public position for personal gain or private advantage—for self or others; and (2) May not receive anything, except from the WSIB, for performing, omitting, or deferring the performance of any official WSIB duty. He remarked that WSIB policy is stricter than the state ethics law.

Mr. Silver reviewed the policy on gifts, and what is considered a gift. He discussed the main policy exception on gifts involving conference travel, attendance, materials, and acceptance of meals and beverage. The Executive Ethics Board has provided that the WSIB can accept these gifts if it is deemed to have paid for them. Side letter provisions are in place to clarify that WSIB has paid for attendance, travel, and related expenses through fees paid through limited partnership and contract agreements.

Mr. Silver reviewed and responded to member questions on WSIB policy and ethics law requirements pertaining to confidential information, use of state resources, employment after state service, personal investments, monitoring and financial form filing, recusal, and sanctions for violations of the state ethics law.

Mr. McElligott requested a fiduciary education session for the Board.

[The Board took a recess at 10:50 a.m. and reconvened in open session at 11:04 a.m.]
[Ms. Schurke arrived at 11:04 a.m.]

REAL ESTATE RISK EDUCATION SESSION

Mr. Draper introduced the real estate risk education session. He said the goal of the session was to increase understanding of risk in the real estate portfolio and to better define terminology related to real estate risks.

He listed WSIB investment beliefs relevant to the discussion: (1) Only some investment risks can be clearly defined and measured at the present time; (2) Risk must be considered at the portfolio level; and (3) The WSIB should be compensated for the investment risk it takes. The WSIB takes a relatively high amount of overall risk in its real estate portfolio.

Mr. Draper identified that governance, market, exit, development, foreign, political, structure, and property type risks are standard and routinely examined when looking at partnerships, along with entitlement, leverage, operating, key person, and management/other risks. He said some risks interrelate. He described and provided examples of each risk category and what can be done to mitigate them. He noted that the Real Estate unit spends a large amount of its time evaluating risk.

A discussion ensued regarding the real estate allocation level.

Chair Gorton announced that the Board would go into executive session to discuss financial and commercial information relating to an investment since public knowledge regarding the discussion would result in loss to the funds managed by the WSIB or would result in private loss to the providers of the information. He said the executive session was expected to last until 11:53 a.m., at which time the Board would reconvene in open session.

[The Board went into executive session at 11:42 a.m. and reconvened in open session at 12:15 p.m.]

Mr. Draper then began a review of how the WSIB mitigates portfolio-level risk in real estate. He said that there is no substitute for hands-on portfolio knowledge. The most heavily-used risk mitigation within the portfolio is diversification: by geography, partners, property type, strategy, demographics, and property life cycles. The WSIB wants to continue to be a leading edge investor, which does not necessarily have to mean more risk. Risk assessment and quality underwriting are vital. He noted that in spite of our best efforts, we will still occasionally make mistakes and have some investments underperform. It is critical to invest with the best partners, be consistent in our approach, and to keep a long-term perspective.

Messrs. McElligott and Kaminski thanked Mr. Draper and staff for their hard work.

[The Board took a recess at 12:23 p.m. and reconvened in open session at 12:52 p.m.]
[Senator Brown was no longer in attendance at 12:52 p.m.]

ADMINISTRATIVE COMMITTEE REPORT

Investment Officer Compensation Study

Chair Gorton referenced the new proposed salary ranges for the Board's consideration. Mr. Dear clarified that the proposed ranges are based on the current compensation statute and staff would request an update after the new statute becomes effective.

Mr. McElligott moved that the Board adopt the new proposed salary ranges for Investment Officers. Mr. Petit seconded the motion.

<u>Job Classification</u>	<u>New Range</u>
Assistant Investment Officer	\$57,259 - \$80,163
Investment Officer	\$82,682 - \$115,755
Assistant Senior Investment Officer	\$114,071 - \$159,700
Senior Investment Officer	\$154,599 - \$216,439
Chief Investment Officer	\$226,075 - \$316,505

Representative Sommers asked why the new statute was not used in the process. Mr. Dear said that the timetable for developing the 2009-2011 biennium budget required survey data before the new law takes effect.

Mr. Masten said he will support the motion, but is concerned that other state salary surveys take effect only if the classifications are 25 percent below their average. Treasurer Murphy observed that the percentage increase among the investment officer classifications seems all over the place.

Ms. Eckstein said surveyed salary levels are benchmarked to the market. These levels are based on public pension funds of similar size to the WSIB, and consideration of current job descriptions. The methodology used is the same as with past surveys. Ms. Whitmarsh said this survey is based on the current statute, and the market data revealed a wider spread between position increases than in previous surveys. The survey did not include incentive pay, only base compensation.

Treasurer Murphy stated a specific concern with the \$100,000 difference between the top of the Senior Investment Officer and Chief Investment Officer classifications. He believes the proposal needs more work.

Chair Gorton said the Board is to look at the average by law, and the Board must consider the range between top and bottom. Mr. Masten pointed out the law is not specific on the range. Mr. Dear confirmed the range percentage is the Board's decision.

A discussion ensued on use of the common method of using salary surveys in establishing pay. Ms. Whitmarsh emphasized that, while JLARC had not yet provided comment on this survey, they had commented on survey methodology in the past and R.V. Kuhns had incorporated JLARC's suggestions. There has been no subsequent change in methodology. Salaries would not take effect until 60 days after JLARC's comment, and other notifications are made. Ms. Whitmarsh said staff would come back to the Board in June if any issues surface.

Treasurer Murphy said he would like to see significantly narrower ranges. He believes the top of lower classifications should be within the bottom of the next higher classification.

The above motion passed, with Treasurer Murphy voting no.

Sudan Resolution Annual Report

Chair Gorton said the Sudan Resolution Annual Report was provided as an information item. There were no questions from the Board.

Treasurer Murphy asked if there was any report from the Committee on the RFQQ – Board Consultant and Board Travel Policy 2.00.260 Revision agenda items. Chair Gorton reported that the Committee voted on both items and neither were brought forward for the Board’s consideration.

Treasurer Murphy recalled the Board discussed the travel policy at its last meeting, and he believed staff’s work was to be brought back to the Board. Treasurer Murphy said he does not think the Board should restrict international travel. Mr. Dear noted the current policy is less restrictive than the proposal considered by the Administrative Committee. Chair Gorton said the current policy would not change.

Assistant Attorney General’s Report

Mr. Silver had nothing to report.

AUDIT COMMITTEE REPORT

Mr. Petit reported that the Audit Committee met on April 1. Three external audits were discussed: (1) The upcoming State Auditor’s Office Fiscal Year 2008 Accountability Audit will include a review of the: custodial bank transition, contracts, real estate compliance, the Agreement Tracking System reconciliation with Financial Control Systems, investment holdings, conflict of interest, and travel; (2) The Committee approved a scope of work for the next financial statement audit, and after a review of the external firm’s independence, appointed Peterson Sullivan PLLC to conduct the Fiscal Year 2008 financial statement audit; and (3) The WSIB was one of ten state agencies, ten counties, and ten cities selected by the State Auditor’s Office (SAO) for a performance audit of its public records request policies and procedures. The SAO found WSIB responsive in eight of the ten unannounced public records requests, and also cited WSIB best practices in draft reports.

Audit Committee Charter 1.00.130 Revision

Mr. Petit said that he worked with Vice Chair Matheson and Ms. Killman earlier this year to map the Audit Committee Charter responsibilities to the meeting agenda items. During the working sessions, the list of standing Audit Committee meeting agenda items grew, and potential Charter revisions were identified. The proposed revisions add clarity to the Committee’s oversight responsibilities, and capture requirements previously missing from the Charter, but found in other Board policies.

Mr. Petit moved that the Board adopt Audit Committee Charter 1.00.130 Revision. Mr. Ragan seconded the motion.

In response to Treasurer Murphy's question relating to the conflict of interest review described on page 4, Ms. Killman said the Charter revision simply incorporates language already contained in the Board's Conflict of Interest Policy. Mr. Dear said the Audit Committee already performs the activity, and the recommendation is to include it in its Charter.

The above motion carried unanimously.

Proxy Voting Policy 2.05.200 Revision

Mr. Petit described the proposed change to Proxy Voting Policy 2.05.200, which indicates that the WSIB will support proposals allowing shareholders to vote on compensation committee reports, thus creating another avenue by which it can hold corporate boards accountable for their compensation practices.

Mr. Petit moved that the Board adopt Policy 2.05.200 Proxy Voting Guidelines, as amended, to include support for shareholder proposals giving shareholders an advisory vote on the compensation committee's report on executive compensation. Mr. Ragan seconded the motion.

Mr. Nierenberg and Mr. Kaminski shared their concern that the Board should focus its votes where it can make a difference, rather than on advisory votes that have no effect. Treasurer Murphy supports the effort, stating it is another way for the Board to express its opinion. A discussion ensued on proxy voting practices, and the securities lending program's affect on the WSIB's ability to vote all of its shares.

The above motion carried unanimously.

Mr. Masten asked for a discussion on how the WSIB can pull back loaned securities in order to vote proxies, including a cost analysis and Board policy. Mr. Nierenberg agreed, suggesting that the Board focus on where it thinks there are important issues or egregious offenses, and where it believes victory can be attained.

Chair Gorton directed the Audit Committee to address the request and bring it back before the Board.

PUBLIC MARKETS COMMITTEE REPORT

U.S. Enhanced Indexing Review

Mr. Masten reported that the Public Markets Committee met on April 1 to continue the U.S. enhanced index program review. In February, the Committee heard presentations from the three U.S. equity enhanced index managers: Barclays Global Investors, State Street Global Advisors, and Western Asset Management Company. Since that meeting, staff conducted a complete evaluation of the U.S. enhanced index equity program including on-site visits and detailed reviews of the managers' organization, philosophy, process, risk control, and investment performance results. This analysis, including discussion of proprietary techniques and specific fee schedules that are not subject to public disclosure, was discussed by the Committee in an executive session.

Chair Gorton announced that the Board would go into executive session to discuss financial and commercial information relating to an investment since public knowledge regarding the discussion

would result in loss to the funds managed by the WSIB or would result in private loss to the providers of the information. He said the executive session was expected to last until 2:00 p.m., at which time the Board would reconvene in open session.

[The Board went into executive session at 1:51 p.m. and reconvened in open session at 2:28 p.m.]

Mr. Masten moved that the Board maintain the U.S. enhanced index program and direct staff to amend the U.S. enhanced index investment manager contracts as appropriate. Further, that the Board direct staff to conduct a search to build a more optimal enhanced index program. Mr. Ragan seconded the motion.

Mr. Masten said the Board would have another opportunity to examine the use of enhanced equity managers for U.S. equities before staff hires any additional managers. Treasurer Murphy commented he was and remains concerned about enhanced indexing, but supports the motion.

The above motion carried unanimously.

PRIVATE MARKETS COMMITTEE REPORT

Mr. McElligott reported that the Private Markets Committee met on April 3 to discuss five investment recommendations.

Private Equity Investment Recommendation – HarbourVest International Private Equity Partners VI Asia Pacific/Emerging Markets Funds, L.P.

Mr. McElligott moved that the Board invest up to \$50 million in HarbourVest International Private Equity Partners VI Asia Pacific, L.P., and up to \$50 million in HarbourVest International Private Equity Partners VI Emerging Markets, L.P., for a total of \$100 million, plus fees and expenses, subject to continuing due diligence and final negotiation of terms and conditions. Mr. Masten seconded the motion.

Mr. McElligott reported that both of these funds are components of the HarbourVest International Private Equity Partners VI fund-of-funds program and are market-specific funds tailored to investors who seek exposure to the Asia Pacific region or other diverse emerging markets. Asia Pacific L.P. is a \$500 million fund that will invest in primary partnerships in the Asian Pacific region with buyout or venture strategies. Emerging Markets L.P. is a \$300 million fund that will invest in partnerships in markets such as Africa, Israel, the Middle East, Latin America, and Russia. The WSIB is a long-time investor with HarbourVest, having invested over \$600 million in 12 partnerships since 1982. The recommendation is based, in part, on HarbourVest's deep, experienced investment team; proven global investment strategy; ability to access top-tier managers; and solid Asia Pacific experience. In addition, HarbourVest is always willing to share market intelligence and due diligence with staff.

The above motion carried unanimously.

Private Equity Investment Recommendation – Banc Fund VIII, L.P.

Mr. McElligott moved that the Board invest up to \$100 million, plus fees and expenses, in Banc Fund VIII L.P., subject to continuing due diligence and final negotiations of terms and conditions. Mr. Masten seconded the motion.

Mr. McElligott reported that Banc Fund VIII will focus primarily on sub-regional depository companies, including commercial banks, savings banks, and savings and loan associations likely to be acquisition targets as the industry continues to consolidate. The WSIB has invested in three prior Banc Funds. The recommendation is based, in part, on Banc Fund's experienced, stable management team with extensive financial services expertise; differentiated, proven strategy; consistent, strong returns and low loss ratios; portfolio fit; timely and attractive opportunity; and successful relationship.

The above motion carried unanimously.

Private Equity Investment Recommendation – KSL Capital Partners Supplemental II, L.P.

Mr. McElligott moved that the Board invest up to \$50 million, plus fees and expenses, in KSL Capital Partners Supplemental II, L.P., subject to continuing due diligence and final negotiations of terms and conditions. Treasurer Murphy seconded the motion.

Mr. McElligott reported that KSL Supplemental II will make select investments alongside KSL Capital Partners II, L.P., to provide additional equity on larger, more operationally-intensive investments in the travel and leisure sectors. The fund will continue KSL's proven niche investment strategy, which is to pursue acquisitions of under-managed or under-capitalized businesses in the hospitality, recreation, clubs, real estate, and travel services sectors. The WSIB invested in KSL Capital Partners II, L.P. in January 2006. The recommendation is based, in part, on KSL's experienced management team; strong realized performance; focused, niche strategy; and excellent portfolio fit. In addition, the fund will provide additional equity per deal for select KSL II deals at the same terms but at reduced fee and carry.

The above motion carried unanimously.

Real Estate Investment Recommendation – Lone Star Fund VI (U.S.), L.P.

Mr. McElligott moved that the Board invest up to \$600 million, plus fees and expenses, in Lone Star Fund VI (U.S.), L.P., subject to continuing due diligence and final negotiation of terms and conditions. Mr. Masten seconded the motion.

Mr. McElligott reported that Lone Star's strategy is to take advantage of mispriced opportunities in distressed markets, targeting a broad range of financial and other investment opportunities, including investments in non-performing loans, secured and corporate unsecured debt, and financially-oriented operating companies with an emphasis on the acquisition of assets backed by

real estate collateral. The WSIB has invested a total of \$1.455 billion in five Lone Star funds since 1996. The recommendation is based, in part, on Lone Star's proven management team, attractive strategy, experience, and track record. The current turbulence in the credit markets makes this an especially attractive time to invest with this group.

The above motion carried unanimously.

EMERGENCY RESERVE FUND POLICY 2.35.300 REVISION

Ms. Will introduced the recommendation to change Emergency Reserve Fund (ERF) Policy 2.35.300. In 2007, the Legislature created the Budget Stabilization Account which replaces the ERF that WSIB manages. Operationally, the new account is vastly different than the ERF and has a requirement that one percent of the state's general revenues are transferred to it annually each June 30, but in investment terms they are very similar. There are limited means to invest the account as it does not have a constitution exemption; therefore, it can only be invested in government securities. The investment objectives are the same as for the ERF. Staff recommends renaming the ERF Policy to Budget Stabilization Account Policy 2.35.300, and updating statutory references.

Treasurer Murphy moved that the Board adopt the recommended changes to the Emergency Reserve Fund Policy 2.35.300. Mr. Masten seconded, and the motion carried unanimously.

BOARD DISCUSSION

There was nothing to discuss.

OTHER ITEMS

There was no further business to come before the Board. The meeting adjourned at 2:38 p.m.


Glenn Gorton
Chair

ATTEST


Joseph A. Dear
Executive Director