WASHINGTON STATE INVESTMENT BOARD
Board Meeting Minutes
July 15-17, 2008

The Washington State Investment Board met in open public session at 1:30 p.m. on July 15, 2008, in the Adams Room at Skamania Lodge, Stevenson, Washington.

Present:	Glenn Gorton, Chair Sandy Matheson, Vice Chair Charlie Kaminski John Magnuson Allan Martin George Masten Pat McElligott Treasurer Mike Murphy Bob Nakahara David Nierenberg Mason Petit Mike Ragan Jeff Seely Representative Helen Sommers
Absent:	Senator Lisa Brown Judy Schurke
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 Bill Kennett, Senior Investment Officer – Fixed Income Phil Paroian, Senior Investment Officer – Public Equity Tom Ruggels, Senior Investment Officer – Private Equity Diana Will, Senior Investment Officer – Asset Allocation Kristi Haines, Executive Assistant Steve Lerch, Research Director James Mackison, Director of Technology and Innovation Beth Vandehey, Risk and Compliance Director Marie Repcik, Administrative Assistant
	Brian Buchholz, Assistant Attorney General Steve Dietrich, Assistant Attorney General Wes Edens, Fortress Investment Group LLC Rick Funston, Deloitte & Touche LLP Arjun Divecha, GMO Charley Ellis, Author and Investor Chip Kaye, Warburg Pincus LLC Tom Kubr, Capital Dynamics Tim Morris, Morgan Stanley Wendy Malaspina, GMO

July 15, 2008

Chair Gorton called the meeting to order and took roll call.

ADOPTION OF MINUTES – JUNE 19, 2008

Mr. McElligott moved to adopt the June 19, 2008, Board minutes. Mr. Masten seconded, and the motion carried unanimously.

PUBLIC COMMENT

There was no public comment.

[Mr. Seely arrived at 1:33 p.m.]

STRATEGIC PLAN UPDATE

Mr. Dear introduced the mid-year update of the strategic plan. He reviewed the changes in market environment, staffing, and Board membership. He commented that it is an interesting time in terms of risk and opportunity.

[Treasurer Murphy arrived at 1:37 p.m.]

Mr. Dear described the five key drivers of the value chain, which is how the agency's mission is achieved. He compared fund performance from 2007 to 2008. He noted that negative returns are anticipated for the 12-month period ended June 30, 2008.

Mr. Dear said the 2008 initiatives were built around the strategic framework of value, capacity, and support, which rest on the foundation of a skillful Board. He reviewed progress to date on the risk, investment analysis, and tactical value initiatives; collaboration and corporate governance support initiatives; and, organization and Board capacity initiatives, including the 6-year plan, biennial budget, back and middle office improvements, performance management, and Board education.

[Mr. Kaminski arrived at 1:56 p.m.]

Mr. Dear provided an updated analysis of how the Board spends its time, which revealed that Board time spent on strategy had increased to 25 percent. Mr. Nierenberg recommended that staff analyze time spent on risk management going forward.

Mr. Dear suggested that challenges going forward could include stress on the portfolio, as negative markets would make the 8 percent return objective harder to achieve. He explained that due to the WSIB's asset mix, valuations sustain performance longer than other pension funds as the cycle goes down, but there could be underperformance as markets come back. Mr. Dear pointed out that Board and staff turnover could exacerbate that situation, in that the program and strategy could be questioned and abandoned at the wrong time.

The Board discussed the need to articulate and document its strategy. Mr. Nierenberg suggested that incoming Board members should receive a briefing on the investment beliefs.

[Vice Chair Matheson arrived at 2:18 p.m.]

Mr. Petit suggested developing a white paper to respond to public pension fund critics. Mr. McElligott suggested that it should also describe how the WSIB's structure is different than other pension funds. Mr. Dear said staff developed a white paper that sets forth the rationale behind the Commingled Trust Fund (CTF) private equity asset allocation decision approved by the Board in November 2007 and it could be expanded to include other asset classes. Vice Chair Matheson said that a communication relating to concerns regarding the 8 percent return would be helpful to associate short-term results with long-term goals.

[The Board briefly recessed at 2:39 p.m. and reconvened in open session at 2:58 p.m.]

ANNUAL COMMITMENT PLAN UPDATES
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 about an hour, at which time the Board would reconvene in open session.

[The Board went into executive session at 2:59 p.m.]

Private Equity
Real Estate

[The Board concluded its executive session and reconvened in open session at 4:57 p.m.]

DISCUSSION
Chair Gorton announced that Mr. Masten received the Institute of Fiduciary Education's leadership award at the recent Market Makers conference. The Institute of Fiduciary Education's Leadership Award recognizes those persons who make important contributions to the industry.

[The Board recessed at 4:59 p.m. and reconvened in open session at 7:05 p.m.]

DINNER PRESENTATION: CURRENT OPPORTUNITIES
Mr. Edens discussed the recent credit disruption and investment opportunities within the current environment.

[The Board recessed at 9:06 p.m. on July 15, 2008.]

July 16, 2008

[The Board reconvened in open session at 8:30 a.m. on July 16, 2008.]

Chair Gorton called the meeting to order and took roll call.

THE RISK INTELLIGENT ENTERPRISE
Mr. Funston introduced himself and described his background and experience. He demonstrated that the more focused one is on an event, the more likely it is that a change in circumstances or the environment can be missed. He said the current environment is complex and everything has changed but human nature. It is important to understand human nature to attempt to manage it.

Mr. Funston said that risks are necessary to be successful and the key is to know what risks to avoid. The simplest way to describe risk management is how to get smarter about things you do to be successful. Mr. Funston described the value of taking risks intelligently. He said there are rewarded risks, such as developing new products or going into new markets. There are also unrewarded risks, such as quality failures and lack of integrity in financial statements. He said it is important to protect what you have in the pursuit of what can be gained. There are comparisons with total quality management, which has the objective to bring down total cost through comprehensive measurement and management of all business processes.

Mr. Funston described the current operating environment, which is not business as usual. He said that issues that affect the current operating environment do not operate in isolation. He suggested that most of the modern financial and economic models are fatally flawed because they exclude turbulent periods. Vice Chair Matheson asked if reactions to the current environment are irrational. Mr. Funston responded that modern financial theory suggests that markets are rational but he disagrees. He encouraged the Board to improve its resilience. He said risk management is needed when modern portfolio theory fails.

Mr. Funston described the ten fatal flaws in modern risk management: (1) lack of situational awareness; (2) failure to imagine failure; (3) failure to consider speed; (4) banking on false assumptions; (5) lack of corroboration/credibility; (6) failure to maintain a margin of safety; (7) short-termism; (8) failure to manage complexity; (9) lack of operational discipline; and, (10) failure to take enough of the right risks.

[The Board briefly recessed at 10:17 a.m. and reconvened in open session at 10:37 a.m.]

[Mr. Martin arrived at 10:37 a.m.]

Mr. Funston conducted an opinion poll of voting and nonvoting Board members and staff on how well they believe the WSIB is doing with regard to each of the ten fatal flaws in modern risk management. The Board discussed the results and requested further examination at future meetings.

Mr. Nierenberg commented that failure to imagine failure and failure to consider speed are not currently addressed within staff's due diligence write-ups. Mr. Magnuson agreed that those risks should be included, and said he would also like to see a write-up on what could occur if an investment failed completely. Mr. Kaminski suggested that discussion of risk should be an explicit activity built into Board agendas, such as an overview of what may happen within a company, sector, or asset class. Mr. Nakahara said it is important to stress test the business model and each asset class. Mr. Funston suggested that the Board build "white hat" testing into its decision-making process, and every decision should also include discussion on where a process could fail, how it could fail, and what can be put into place to prevent failure.

Mr. Funston discussed how companies with good enterprise management processes responded more favorably to the sub-prime crisis. He identified four categories for failure modes: revenue growth, operating margin, capital efficiency, and expectations, and said these tend to fall into five buckets: people, processes, systems, facilities, and external factors. The key is to start with the biggest risks by determining what you are absolutely dependent on, how long can you manage without it, how it could fail, what would cause a failure, the effects of the failure, how long it would take to recover, and the cost. Mr. Funston suggested that for every risk, there would be someone to manage it throughout its life cycle. A threshold for reporting risks to the Board should be determined, and a crisis response should be in place for reputation issues.

Mr. Funston provided a list of characteristics of the Risk Intelligent Board and Leadership. He listed eight basic questions to address in becoming a Risk Intelligent Enterprise™: (1) what are the risk events that are intrinsic to your business? (2) Which events could ruin the company? (3) How fast could they happen? (4) How prepared are you to prevent or respond to those risk events? (5) How exposed are you? (6) For the greatest exposures, how likely are they? (7) What can you do to practically reduce the biggest most likely exposures given your limited resources? (8) How do you know your answers are reliable?

Mr. Funston provided samples of risk management assessment processes. Mr. Petit said that examination of the risks is a lot of work, and the Board would need to rely on staff to further develop risk intelligence. He noted the opinion polls would open a lot of discussion. Mr. Nakahara said it is important for organizations to have safety surrounding such discussions to harvest thoughts. In response to Mr. Kaminski's question, Mr. Funston noted Hewlett Packard and DuPont as having best practices in this area.

In response to Mr. Masten's comments, Mr. Funston said a challenge for supervisory boards is to simplify and avoid bureaucracy. Data is very important but it needs to be useable and streamlined to get the most critical information and key factors. Mr. Funston said the Board can get reasonable assurance, but should operate with a "noses in, hands off" technique.

[The Board briefly recessed at 12:03 p.m. and reconvened in open session at 1:35 p.m.]

EMERGING MARKETS OPPORTUNTIES AND RISKS

Mr. Bruebaker introduced Messrs. Kubr, Divecha, Kaye, and Morris to discuss emerging markets, which staff believes to be a growth area over the next 10 to 20 years.

Mr. Kubr introduced the panel discussion, which began with a general overview of big issues in emerging markets, followed by a discussion of running private equity and real estate companies in the environment.

Mr. Divecha shared his view that emerging markets may have a good 10- to 20-year cycle because the environment is different than the past. There is real growth in economies in terms of incomes and spending power, and the lower cost of capital creates wealth and a demand for investment. He said emerging markets growth is fueled by globalization, and increasing exports is the source of real growth. He described the first and biggest risk within emerging markets as protectionism that could come from the West. He said that emerging markets are less dependent on its exports to the U.S. and becoming more dependent on consumption within other emerging markets. Mr. Divecha described how foreign exchange reserves, providers of capital to developed markets, decreasing debt, and interest rates have driven the lower cost of capital in emerging markets. He said short-term concerns for emerging markets include valuations and inflation.

Mr. Kaye noted the increase in countries experiencing growth, versus those in recession. More people in more places around the world are doing better. Emerging market countries are driving a larger share of global gross domestic product (GDP) growth. Private consumption in emerging markets is accelerating while it stagnates in developed markets. Fixed investment growth is positive in emerging markets and declining in developed markets. Foreign exchange reserves held by emerging market countries increased dramatically between 1997 and 2007.

Mr. Kaye said that the case for private equity in emerging markets includes: sound long-term economic growth trajectories, entrepreneurial culture breeding fast-growing companies, inefficient markets and frequent dislocations in different sectors, and limited funding from banks and capital markets. He described specific investment opportunities based on mega-trends. Mr. Kubr described challenges as emerging markets' immature infrastructure, herd mentality which could lead to volatility, maintaining balance and perspective, and consideration of business versus politics.

Mr. Morris said that Morgan Stanley has positioned itself in emerging markets for growth in real estate. He demonstrated that emerging markets have significantly outperformed the U.S. in recent years and said he expects the trend will continue. A shortfall of quality real estate assets currently exists in emerging markets. Mr. Morris said that economic activity, employment, population growth, urbanization, and major cities are trends that are driving the demand for real estate.

Mr. Nierenberg remarked that the Board should have a view on its target percentage point for emerging markets across all asset classes and within each asset class, taking compounding effects into consideration.

Mr. Kubr presented data regarding the growth in Asian private equity, including Australia, New Zealand, Japan, Hong Kong, Taiwan, Singapore, Philippines, Thailand, Indonesia, Malaysia, South Korea, China, and India. He said investment patterns and styles within the countries and regions vary greatly and stressed the importance of exit scenarios.

Mr. Kubr discussed the challenges in finding good funds in Asian emerging markets. He said necessary elements are a free economy, a working bankruptcy system, no corruption, and no state interference. He described issues with the immature marketplace, and country specific issues.

[The Board briefly recessed at 3:20 p.m. and reconvened in open session at 3:41 p.m.]

Mr. Kubr said that private equity investment in emerging markets is challenging due to liquidity issues, but there are huge opportunities accompanied with risk. Mr. Bruebaker said the Board needs to believe that emerging markets is the place to be over a 15- to 30-year time period as it is expensive to get in and out of investments. He posed the question if there would be conviction to stay the course if an adverse event occurs. Mr. Morris commented that diversification is key.

Mr. Kaminski asked if there are early indicators of adverse events the Board should watch for. Mr. Divecha mentioned that protectionism, individual country valuation and macroeconomic threats, momentum, politics, relationships, and other subjective impacts should be examined. Mr. Kaye added that it also depends on the asset style. Mr. Kubr said his view is to find the best managers, regardless of the country.

[Mr. Seely left the meeting at 4:22 p.m.]

A discussion ensued regarding the rapid change occurring in China and global warming.

Mr. Kaminski asked which countries look good in South America and Africa, aside from Brazil and South Africa. Panelists mentioned Nigeria, Columbia, Morocco, Nigeria, Senegal, and Egypt. Mr. Divecha said Vietnam and Libya look good going forward.

[The Board recessed at 4:58 p.m. and reconvened in open session at 7:00 p.m.]

DINNER PRESENTATION

Mr. Ellis introduced his July 17 presentation relating to investment management and the work of the Board.

[The Board recessed at 8:52 p.m. on July 16, 2008.]

July 17, 2008

[The Board reconvened in open session at 8:36 a.m. on July 17, 2008.]

Chair Gorton called the meeting to order and took roll call.

BOARD GOVERNANCE DISCUSSION

Mr. Ellis began his presentation by stating that governance is useful with very good management and Washington is as good as they get and better. He said any emphasis placed on governance is value added. It is important to hire the best managers and monitor their consistency.

He said governance is about long-term policies and people. Governance is about determining the strategy an institutional investor uses to achieve its return goal. The strategy has to be appropriate for the fund, its structure, time horizon, markets it invests in, and for the investment managers it uses. The strategy also must protect against the harm that the unexpected can inflict on a portfolio. Defining such strategies is easy; executing them is hard.

Mr. Ellis identified levels of decision as: (A) long-term goal and asset mix; (B) equity mix—growth, value, etc.; (C) active versus passive; (D) manager selection; and, (E) security selection. He observed the most expense accompanies Level E, and the least is Level A. He also noted that boards usually spend the most time on Level E, and the least on Level A. He identified reasons why he believes performance investing is a "loser's game."

Mr. Ellis discussed behavioral economics. He believes that boards compound Levels B and E in decisions. Other potential areas of concern for boards include relationship longevity, member turnover, consultant views, false expectations and false promises by managers, pretense, and business over profession.

Mr. Ellis discussed Yale Endowment's structure, governance, and philosophy. He noted that one key element of Yale's success is the attention it pays to defense.

He said a governing board must know its goals, objectives, and risk tolerance; define investment objectives; select the right managers; set investment policies; and design a strategic portfolio. He provided suggestions on how to "client well" with managers; in other words, how to be a client that the best managers want to serve.

A discussion ensued on hedging definitions and strategies, as well as governance approaches by endowments versus public pension funds.

Mr. Ellis concluded his presentation by stating that board governance provides a major opportunity to add value.

[The Board took a brief recess at 10:20 a.m. and reconvened in open session at 10:51 a.m.]

BOARD EVALUATION DISCUSSION AND FEEDBACK
Chair Gorton announced that the Board would go into executive session at 10:51 a.m. to review and discuss the performance of Board members and of the Board. He said the executive session was expected to last until about 12:00 p.m., at which time the Board would reconvene in open session.

[The executive session concluded at 12:07 p.m. and the Board reconvened in open session.]

OTHER ITEMS
There was no further business to come before the Board. The meeting adjourned at 12:07 p.m. on July 17, 2008.

Glenn Gorton
Chair

ATTEST

Joseph A. Dear
Executive Director