

WASHINGTON STATE INVESTMENT BOARD
Board Meeting Minutes
May 21, 2009

The Washington State Investment Board met in open session at 9:30 a.m. in the boardroom at 2100 Evergreen Park Drive SW, Olympia, Washington.

Present:

- Glenn Gorton, Chair
- Pat McElligott, Vice Chair
- Senator Lisa Brown
- Steve Hill
- Charlie Kaminski
- John Magnuson
- George Masten
- Treasurer Jim McIntire
- Bob Nakahara
- David Nierenberg
- Mason Petit
- Mike Ragan
- Representative Sharon Tomiko Santos
- Judy Schurke
- Jeff Seely

Also Present:

- Theresa Whitmarsh, Acting Executive Director
- Gary Bruebaker, Chief Investment Officer
- Liz Mendizabal, Public Affairs Director
- Steve Draper, Senior Investment Officer – Real Assets
- 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

- Brian Buchholz, Assistant Attorney General
- David Woolford, Capital Dynamics

[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.

ADOPTION OF THE APRIL 16, 2009, MINUTES

Vice Chair McElligott moved to adopt the April 16, 2009, Board meeting minutes. Mr. Ragan seconded, and the motion carried unanimously.

PUBLIC COMMENT

There was no public comment.

EXECUTIVE DIRECTOR'S REPORT

Ms. Whitmarsh provided her monthly report for May on Board governance, investments, budget, staff, public affairs, media, meetings, and open procurements. She said the July Board meeting agenda includes four primary themes: asset allocation, risk, Board governance, and corporate governance. Ms. Whitmarsh said the 2009-2011 Operating Budget approved by the Legislature this session is expected to be signed by the Governor no later than May 19. The WSIB's "appropriated" budget provides additional funding and capacity for 8.0 FTEs. This brings the total "operating" budget for the WSIB to \$29,581,000 and 81.4 annual average FTEs. The funding for the new resource plan includes \$192,000 lease cost to house the new FTEs as well as \$902,000 travel increase.

Ms. Whitmarsh reported on a phone conversation held with Attorney General McKenna relating to the pay-to-play issue involving a few public funds, including New York. She reported the Attorney General was not able to participate in the call on this issue organized for state's attorneys general by New York Attorney General Andrew Cuomo, but has reached out to his colleagues in other states, including New York and New Mexico. The situations there are serious, but Attorney General McKenna told Ms. Whitmarsh that he doesn't see anything to be concerned about in Washington or at the WSIB. He noted that the state can be happy our predecessors had enough foresight to put in place such robust ethics laws, governance, auditing, and control structures. He noted the biggest challenge going forward will be to address the broader industry integrity issues that this event brings up.

[Treasurer McIntire arrived at 9:33 a.m.]

CTF RISK ANALYSIS

Chair Gorton announced 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 Washington State Investment Board (WSIB) or would result in private loss to the providers of the information. He said the executive session was expected to last about 20 minutes, at which time the Board would reconvene in open session.

[The Board went into executive session at 9:40 a.m.]

[Mr. Kaminski arrived at 9:42 a.m.]

[The Board reconvened in open session at 11:00 a.m.]

ADMINISTRATIVE COMMITTEE REPORT

Role of Consultants Policy 1.10.100 Review

Chair Gorton said the Board had asked the Administrative Committee to review the Role of Consultants Policy 1.10.100, which it completed at today's Committee meeting.

Chair Gorton moved that the Board reaffirm approval of the Role of Consultants Policy 1.10.100 with no changes. Vice Chair McElligott seconded, and the motion carried unanimously.

Assistant Attorney General's Report

Mr. Buchholz said a suit against Lehman Brothers for recovery of bond losses was filed yesterday. Public Affairs and Attorney General staff have received a number of media inquiries. The 64-page complaint is available on the WSIB Web site for review. He encouraged members to contact him with any questions.

Chair Gorton announced the Board would go into executive session 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 the executive session was expected to last about 5 minutes, at which time the Board would reconvene in open session.

[The Board went into executive session at 11:02 a.m. It reconvened in open session at 11:07 a.m. and took a break. The Board reconvened in open session at 11:21 a.m.]

ETHICS TRAINING

Mr. Buchholz provided the yearly ethics training. He said the Executive Director is responsible for ensuring that Board members and staff receive timely ethics training annually, in addition to receiving training as a new member or employee. He said the intent of today's training is to ensure members are familiar with key ethics law and conflict of interest policy provisions. Mr. Buchholz described the basic expectations and principles underlying the ethics law. He highlighted rules for

gifts, meals, and travel expenses; confidential information; insider trading; personal investments; financial form filing requirements; employment after state service; use of resources/special privileges; recusal requirements; and potential sanctions for violations. Mr. Buchholz reviewed in detail laws relating to gifts and entertainment activities, and responded to members' questions relating to specific scenarios. Mr. Masten questioned whether past Assistant Attorney General interpretations of the ethics law had been consistent. In response to Representative Santos' question, Mr. Buchholz confirmed there are two different Ethics Boards (Legislative and Ethics) and said he would have to examine whether the Legislative Ethics Board or Executive Ethics Board is responsible for WSIB matters involving its Legislative members, and if differences exist between how the two boards interpret and apply the Ethics laws. Mr. Hill asked that staff examine agendas and planned events when members register for conferences, to assist with identifying situations that may pose potential ethics issues.

[The Board took a brief recess at 12:23 p.m.]

[Senator Brown departed at 12:23 p.m.]

[The Board reconvened in open session at 12:43 p.m.]

QUARTERLY DISCUSSION OF MARKETS

Portfolio Discussion

Mr. Bruebaker reviewed the Implementation Value Added (IVA) Benchmark performance for the quarter ended March 31, 2009. He said financial turmoil in the markets is not yet over. The WSIB recognized investment losses in the first quarter, but continues to have a high quality, globally diversified portfolio that is positioned to perform well over the long term. Investment performance for the quarter was down 11.55 percent. The IVA benchmark was down 9.72 percent. For the quarter and 1-year, the WSIB underperformed the TUCS Public/Corporate Fund > \$1 billion. The fund lost 41 basis points (bps) due to the asset allocation, and 141 bps due to manager decisions. The asset allocation was overweight in Private Equity, which cost 31 bps. Being underweight Tangible Assets hurt the portfolio by 11 bps. In response to Mr. Seely's question, Mr. Bruebaker said that year-end write downs in Private Equity affected the numbers, and more write downs are anticipated. He explained that staff preferred to have write downs done sooner, rather than allowing a trickle-down affect over the next three-year period. Mr. Bruebaker reported that manager decisions underperformance was mostly due to Real Estate write downs. That decision cost 211 bps. It was offset somewhat by Fixed Income performance, which added value of 53 bps. Private Equity

managers' performance helped return 47 bps. Mr. Bruebaker reported that performance is better over the 3-, 5-, and 10-year periods.

A discussion ensued on managers' latitude with FASB 157 (the valuations pronouncement). Mr. Nierenberg commented on a recent discussion of the Audit Committee regarding WSIB's process for implementing FASB 157, by ensuring general partners (GPs) had written policies and were systematically following those policies, but reserves the right for WSIB staff to use their best judgment on valuations. Mr. Bruebaker said staff's internal Valuation Committee documents and evaluates the way GPs are valuing companies, and may opt to take write downs faster. WSIB is not limited by the write downs GPs take, and has documented cases of doing such write downs in the past.

Mr. Kaminski asked if the Capital IQ Web site provides any consistency to valuation process, and if other plans use that data source. And, if that information is not used, how does staff manage the three different valuation marks within FASB 157? Does it tell staff anything about the GPs valuation patterns? Mr. Bruebaker said staff look at valuations for reasonableness and it makes appropriate write downs. He said staff tracks asset sold and how those were valued over the previous year to determine trends that staff should pay attention to. Mr. Bruebaker said the internal rate of return is not directly affected by consistently high or low valuations given that it uses all cash flows and terminal value to calculate the return.

Fixed Income

Mr. Kennett reported that all of the Fixed Income funds did well for the quarter. The Labor and Industries' and Bond Market funds are doing well for the fiscal year, and are expected to outperform their benchmarks. During the first quarter 2009, retirement Fixed Income outperformed by 244 bps; government securities, credit securities, and mortgages all outperformed. Governments did well because TIPS outperformed nominal Treasuries, credits did well because of credit selection, and mortgages did well because of the CMOs. Retirement is expected to be roughly even with its benchmark for the fiscal year, due to poor performance in the first 6 months. He responded to a question from Mr. Kaminski at a previous Board meeting relating to high yield, which is currently returning 25 percent.

Public Equity

Mr. Paroian reported on Public Equity performance for the quarter end, and what has happened since then. There has been a snap back in equity markets since the beginning of March. The WSIB portfolio was positioned neutrally U.S., overweight developed non-U.S., and somewhat underweight emerging markets. The underweighting in emerging markets hurt the portfolio because it performed better during the first part of the year. Mr. Paroian will report at the June Public Markets Committee on steps staff is taking to better fund that allocation. The aggregate positioning of managers within the portfolio is predominately passive. There was a slight overweighting to telecommunications and healthcare, and underweight financials. All other sector weights were within one-half of a percent of the passive benchmark. He reported the first two months of the year were a continuation of the previous year, with financials the worst place to be. The world indices fell about 10 percent; emerging markets only fell about 1 percent. In mid-March, there was a bounce back in equity markets with Dow Jones World up by 20 percent, Dow Jones World Small Cap up 27 percent, and Emerging Markets up over 35 percent. Financials are currently up 33 percent. Commodities are also up. WSIB's managers focus on the long-term, so this volatile environment has been challenging for most managers' short-term. LSV outperformed by over 500 bps in April. Mr. Paroian believes there may still be a re-testing of market lows and there are still issues to be dealt with, such as credit card debt, consumer issues, unemployment, and government debt.

Private Equity

Mr. Ruggels reported on Private Equity cash flows and performance for the fourth quarter of 2008. Deal activity has virtually dried up, and exits are difficult to achieve. Draw downs are approximately \$375 million and distributions \$250 million to date. Mr. Ruggels compared this year to past years' activity levels. He anticipates a slight increase in activity for the second half of the year, but deals are expected to be smaller as GPs are being cautious on new investments, and financing is difficult to obtain for large transactions. He expects to see more momentum on deals by 2010. Distributions are expected to be slow through year end. Mr. Ruggels said IPO windows may open if the public markets continue on a positive trend. A discussion ensued on the progress of the KKR European II Annex Fund deal, and Mr. Ruggels responded to Mr. Magnuson's question about the sources of distributions experienced in past years, and refinancing anticipated in the near term. Mr. Ruggels reported that Private Equity performance was down 19.8 percent for the quarter ended December 31, 2008.

[Treasurer McIntire departed at 1:29 p.m.]

Private Equity

Mr. Woolford reported the S&P 500 total return today is about -35 percent over the past 12 months. He said that is a little below where he estimates the one-year internal rate of return from Venture Economics data that will be released in July. He expects the WSIB will handily beat that benchmark. He believes the worst of Private Equity write downs are over. He described how the high yield market trends are important to private equity, and how GPs respond to those trends. He discussed the amount of levered debt coming due in 2012-2016. He stressed the importance of successfully exiting current investments. He believes distressed managers will become a good place to put money. Mr. Woolford compared cash flow with fundraising. He discussed concerns with fund reserves, high yield maturities, fiscal stimulus and social programs, and counterparty risk.

Real Estate and Tangible Assets

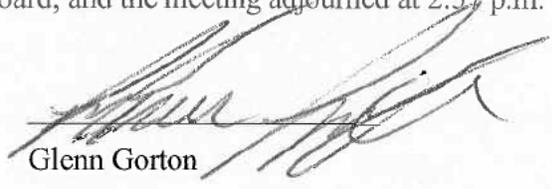
Mr. Draper discussed general conditions in the Real Estate market. Over-leverage and poor underwriting during the last cycle has led to a lack of refinancing in the current environment. He said oversupply is not generally an issue with the current cycle. Refinancing is expected to be a significant issue through 2013. He said lending and debt-level issues need to be dealt with in order for the market to recover. Mr. Draper reported the WSIB real estate portfolio has considerable unfunded commitments, which can be used to de-lever partners' portfolios if necessary.

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[The Board went into executive session at 1:51 p.m., took a brief recess, and reconvened in executive session at 1:56 p.m. The Board reconvened in open session at 2:57 p.m.]

OTHER ITEMS

There was no further business to come before the Board, and the meeting adjourned at 2:57 p.m.



Glenn Gorton

Chair

ATTEST



Theresa J. Whitmarsh

Acting Executive Director