

WASHINGTON STATE INVESTMENT BOARD
Board Meeting Minutes
June 18, 2009

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

Present: Glenn Gorton, Chair
Pat McElligott, Vice Chair
Senator Lisa Brown (via teleconference)
Steve Hill
Charlie Kaminski
George Masten
Treasurer Jim McIntire (via teleconference)
Bob Nakahara
David Nierenberg
Mason Petit
Mike Ragan
Representative Sharon Tomiko Santos
Judy Schürke
Jeff Seely

Absent: John Magnuson

Also Present: Theresa Whitmarsh, Acting Executive Director
Gary Bruebaker, Chief Investment Officer
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

Steve Dietrich, 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.

ADOPTION OF THE MAY 21, 2009, MINUTES

Vice Chair McElligott moved to adopt the May 21, 2009, Board meeting minutes. Mr. Masten seconded, and the motion carried unanimously.

PUBLIC COMMENT

There was no public comment.

EXECUTIVE DIRECTOR'S REPORT

Ms. Whitmarsh provided her monthly report for June on board governance, investments, meetings, staff, public affairs, operations, and open procurements. She reported the Board received a thoughtful letter after its last meeting from former Board member Bev Hermanson, which suggested the Board take a look at its use of executive sessions. Ms. Hermanson noted there has been a noticeable increase in the frequency and duration of executive sessions. Ms. Whitmarsh said the recent market turmoil creates a public desire for the Board to be more transparent. She discussed Ms. Hermanson's concerns with Chair Gorton and the Committee Chairs, and adjustments will be made to meeting agendas based on that feedback. Rather than going in and out of executive session, sessions will be grouped at the end of meetings so the public can leave. The standing Board Governance executive session discussion was removed from the agenda as it was rarely used; however, the Chair can call executive session whenever appropriate. Staff will also give its strategy discussions in open session, and separate confidential portions for executive session.

Ms. Whitmarsh thanked Ms. Hermanson for sharing her views.

Ms. Whitmarsh announced a hedging research workshop is planned for the September Board meeting. She also mentioned the three open procurements, and reminded the Board of the quiet period required by policy. Potential vendors should be referred to the contracts manager.

In response to a request from Mr. Ragan, Mr. Bruebaker provided an update on the potential merger of Barclays Global Investors and BlackRock.

[Ms. Schurke arrived at 9:40 a.m.]

[Senator Brown was in attendance via teleconference at 9:46 a.m.]

INVESTMENT BELIEFS DISCUSSION

Mr. Bruebaker said he appreciates the opportunity to discuss Investment Beliefs again. He defined investment beliefs as fundamental assumptions or principles upon which an investment program and its policy are premised, and capture the essence of an investment philosophy. He reviewed key belief areas. Mr. Bruebaker believes investment beliefs are the foundation of the entire investment program. Asset allocation, portfolio construction, manager structure, staff organizational structure and resources, performance measurement, and risk management systems are all defined by investment beliefs. Beliefs also drive how time and energy are invested. Explicit beliefs aid good governance by guiding decision-makers in developing, executing, and monitoring investment strategies. Sound beliefs also aid external and internal communications.

Mr. Bruebaker said some of the challenges include identifying and agreeing on investment beliefs, distinguishing between beliefs we want and those we have, and human behavior. Beliefs are often counter-intuitive and highly influenced by recent events. He believes beliefs are only truly tested during times of financial crisis. Mr. Bruebaker reviewed Commingled Trust Fund (CTF) returns ended March 31, 2007, and March 31, 2009, to demonstrate how much the environment had changed in a 24-month period. Mr. Kaminski said it shows how much short-term performance moves and dominates long-term performance. Mr. Bruebaker referred to a comment from former Board member Helen Sommers, "Now that we've built this perspective and history, the challenge is to ensure its succession with future boards." He said reviewing the investment beliefs is an important step to confirm the foundation of the asset allocation work, and perhaps help ensure its succession with future boards. Mr. Bruebaker referred to a recent article in the *International Journal of Pension Management* about the importance of having investment beliefs to avoid the risk of assessing new strategies and making *ad hoc* changes that could create suboptimal results.

According to the article, its survey found that publication of investment beliefs by pension funds is still relatively rare.

Mr. Bruebaker said staff had presented 19 beliefs to the Board in November 2007, but he would present only 16 today. He explained that three previous beliefs were similar and combined into one, and another was removed as it actually conflicted with another belief and was not consistent with the historic management of the investment portfolio. He reminded the Board that Cortex originally took on the project of developing investment beliefs, but it was not well received by the Board. Mr. Bruebaker and his investment staff took on the project, and attempted to deliver what it felt the Board's investment beliefs are. Mr. Bruebaker pointed out that it is staff's job is to implement the Board's beliefs. One fundamental disagreement between staff and Cortex was a belief that assets should be managed to liabilities. A discussion ensued on the strategy difference in matching assets to liabilities versus maximizing returns.

Mr. Bruebaker said the first investment belief is the most obvious: (1) the mission of the fund is to maximize returns at a prudent level of risk. The time horizon for this mission is long-term.

Investment beliefs relative to risk are: (2) only some investment risks can be clearly defined and measured at the present time; (3) the WSIB should be compensated for the investment risks it takes; and (4) risk must be considered at the portfolio level.

In response to a concern raised by Representative Santos, Mr. Bruebaker changed the wording of the third investment belief to: *the CTF should be compensated for the investment risk it takes.*

Relative to the asset allocation strategy, investment beliefs are: (5) a broadly diversified portfolio is preferable to a liability-driven portfolio because it offers higher expected returns while also assuring benefit security over the long-term; and (6) the relative performance of asset classes and investment styles is generally subject to reversion to the mean, although timing such move is challenging.

Investment beliefs relative to active management are: (7) active management in an asset class is warranted if: (a) the asset class, segment(s) of the asset class, or investment strategy is reasonably inefficient; (b) there exist managers or partners with skill, persistent performance, and sufficient capacity to meet the WSIB's needs; and (c) the WSIB is able to cost-effectively identify and retain those skilled managers or partners; (8) while skilled private equity and real estate partners demonstrate persistence in performance, even they will inevitably have less successful funds; therefore there is a need for diversification among general partners; (9) investment or asset class constraints and/or mandates reduce investment returns; and (10) all good investment opportunities attract investment capital and so do many poor investment opportunities.

Relative to performance management, investment beliefs are: (11) the primary performance measure for the total fund is performance relative to the fund's passive policy benchmark; (12) the most relevant performance measure for a public market investment manager is performance relative to an appropriate passive market benchmark; (13) currently available performance benchmarks for private markets have significant shortcomings and should be used with discretion; and (14) expenses of the fund are assets of the trust and, therefore, should be carefully measured and managed.

Investment beliefs relative to organizational core competencies are: (15) the WSIB must fulfill the mission of the fund in a manner consistent with the highest fiduciary standards. In keeping with this

belief, we abide by the following principles: (a) integrity is not negotiable and (b) prudence is best demonstrated by a well-documented and sound process; and (16) the success of the investment program and the fulfillment of our mission does not depend on a single competency, but rather requires multiple competencies: (a) clear, rational, and strongly held investment beliefs; (b) excellence in board governance; (c) highly skilled staff; (d) alignment of investment policies and practices with investment beliefs; (e) operational excellence and continuous improvement; and (f) effective utilization of best-in-class managers, investment partners, and advisors.

Mr. Bruebaker outlined the work of staff and the Board relative to each investment belief. He summarized that investment beliefs help ensure consistency and discipline to an investment process. They are owned by the Board, and implemented by staff.

In response to Mr. Hill's question, Ms. Whitmarsh said, in planning for the July asset allocation, staff looked at a foundation for the Board to build upon. In response, staff has presented information on capital market assumptions in April, risk appetite with its analysis of the CTF at the May Board meeting, and then investment beliefs today. She said staff hopes to gain the Board's conviction in the investment beliefs and its willingness to stay the course, or learn if there is a desire to change any of the beliefs. Mr. Bruebaker invited comments of any kind on the Board investment beliefs. Mr. Masten said it is a very good exercise and he finds it useful. Members come to the Board at different levels of understanding. He is a strong believer in investment policy and hopes the Board stays the course. He has great confidence that markets will return. Mr. Nierenberg commented that, of the five different investment committees he serves on, this board is the only one that articulates its investment beliefs. The exercise is important because investment beliefs help to avoid emotionalism, and also help to support the Board's investment strategy. Treasurer McIntire said he is less optimistic about capital markets, but thinks the Board should persist with what it has laid out, but also look back annually and think about it over time. Senator Brown appreciated the opportunity to review the investment beliefs, to get members in the frame of mind for July meeting and asset allocation decision. Mr. Nakahara said investment beliefs are a foundation to what the Board does, but could be evolutionary in nature. He encouraged staff to consider Representative Sommers' comment about succession with the Board. He suggested staff encapsulate the work thus far to make that available to future boards; for example, documenting milestones such as why three investment beliefs were rearranged or dropped since 2007.

Mr. Bruebaker suggested the Board may want to consider formally adopting its investment beliefs. Mr. Masten suggested it would be appropriate for the Board to review these again and recommend adoption at its July meeting. Mr. Hill said it is important to clarify these investment beliefs relate to the CTF, and not all of the funds under management. Treasurer McIntire suggested the Board also develop investment beliefs for its other funds. Mr. Bruebaker said if the Board reached agreement on the CTF beliefs in July, staff would come back with beliefs relating to Labor and Industries' funds and explore other funds' beliefs at a later date. Representative Santos commented the Board should ensure that stakeholders have the same understanding of what the objectives are for different funds. It is very clear for the CTF that returns are maximized for the benefit of beneficiaries, while taxpayers are the beneficiaries in other funds. She would like the Board to adopt investment beliefs for all funds under management.

[Treasurer McIntire was no longer in attendance via teleconference at 10:44 a.m.]

Senator Brown relayed the Economic Forecast Council announcement this morning that a \$482 million drop is anticipated; \$188 million for this biennium, and the remainder occurring during

the 2011-13 biennium. While the State is still in the black for both this fiscal year and next biennium, it is not by much.

[Vice Chair McElligott departed at 10:47 a.m.]

[Senator Brown was no longer in attendance via teleconference at 10:47 a.m.]

[The Board took a brief recess at 10:47 a.m. and reconvened in open session at 11:01 a.m.]

AUDIT COMMITTEE REPORT

Information Services Board Security Policy Compliance Audit Report

Mr. Petit reported the Audit Committee reviewed the Information Services Board (ISB) Security Policy Compliance Audit Report, issued by the State Auditor's Office. The audit is required once every three years for all state agencies. The report was clean as the WSIB complied with the ISB requirements.

Mr. Petit moved that the Board approve the ISB Security Policy Compliance Audit Report. Mr. Masten seconded, and the motion carried unanimously.

Financial Statement Audit – Approval of Scope of Work

Mr. Petit said the Committee reviewed a proposed Scope of Work for the annual Financial Statement Audit for a new five-year contract period.

Mr. Petit moved that the Board approve the scope of work for an annual audit of the financial statements prepared by the WSIB for the five-year period ending June 30, 2014. Mr. Ragan seconded, and the motion carried unanimously.

Financial Statement Audit – Independence Statement Review and Appointment of External Auditor (Peterson Sullivan)

Mr. Petit reported that staff issued a request for qualifications and quotations for the Financial Statement Audit, and unanimously selected Peterson Sullivan PLLC to recommend for appointment. The Committee met with staff from Peterson Sullivan, and reviewed the independence of the audit firm.

Mr. Petit moved that the Board appoint Peterson Sullivan PLLC to perform the Fiscal Year 2009 audit of the financial statements prepared by the WSIB. Mr. Ragan seconded, and the motion carried unanimously.

Internal Audit Report 2009-03 – Accounting, Pricing, and Unitization of the Commingled Trust Fund and Commingled Monthly Bond Fund

Internal Audit presented the results of the planned review of Accounting, Pricing, and Unitization of the Commingled Trust Fund and Commingled Monthly Bond Fund, indicating the overall assessment is good and there are no recommendations to report.

Mr. Petit moved that the Board approve Internal Audit Report 2009-03, Accounting, Pricing, and Unitization of the CTF and CMBF. Mr. Ragan seconded, and the motion carried unanimously.

Internal Audit Report 2009-04 – Limited Liability Company Processes

Internal Audit presented the results of the planned review of the Board's Limited Liability Company (LLC) processes, indicating the overall assessment was good and two audit recommendations were made.

Mr. Petit moved that the Board approve the Limited Liability Company Processes Internal Audit Report 2009-04. Mr. Ragan seconded, and the motion carried unanimously.

Fiscal Year 2009-2010 Internal Audit Plan

The Committee reviewed the Fiscal Year 2009-2010 Annual Internal Audit risk assessment and resulting plan.

Mr. Petit moved that the Board adopt the Fiscal Year 2009-2010 Internal Audit Plan. Mr. Ragan seconded, and the motion carried unanimously.

Mr. Petit said the Committee also discussed the Audit Recommendations Status Report, Corporate Governance Planning, in preparation for the off-site Board meeting in July, an Enterprise Risk Management Scenario Analysis related to the custody bank, and the Daily Valued Funds Annual Report.

PUBLIC MARKETS COMMITTEE REPORT

Mr. Ragan reported the Public Markets Committee met on June 2 and participated in an education session on the medium- to long-term prospects for emerging markets. The presentation was led by Victor Kohn, Capital International, and included a recap of the emerging markets over the past 15 months; a review of emerging markets' currencies and the changes in emerging markets after the various crises in the 1990s; market fundamentals; demographics; general economic health; and performance. Fundamentally, emerging markets are on solid footing and are staged to grow faster than developed markets. He said the Committee also heard an update on the emerging markets program review and the public equity emerging markets strategy by Phil Paroian. The Committee discussed the desired allocation to emerging markets equity managers; risk of not being invested adequately in emerging markets; ability to use passive options to gain temporary exposure; emerging markets exposure across the entire portfolio; and potential risks and volatility if the current market recovery is not sustained.

ADMINISTRATIVE COMMITTEE REPORT

Ad Hoc Committee Report

Chair Gorton reported the Ad Hoc Committee met on May 21 and June 2 to discuss the next steps in the Executive Director recruitment. He said the Committee heard a presentation in May from the Washington State Department of Personnel (DOP) staff, regarding services their Executive Careers Program unit could offer for the recruitment. DOP made two proposals: one proposal was for DOP to perform a full nationwide recruitment for the Executive Director's position; the second proposal was for DOP to provide support services to liaison between the Committee and an executive recruitment firm during the Executive Director recruitment, with WSIB staff issuing the Request for Proposals (RFP) to hire an executive recruiter. The Committee opted to enter into an interagency agreement with DOP to provide support services. In June, the Committee met again to approve the RFP document staff prepared. The RFP was issued on June 5. The Committee also determined the former document used as the Executive Director position description during the 2002 recruitment, would be used as an attachment to the RFP. The Committee discussed that part of the work of the

executive recruiter would be to further review the position description through meetings with all Board members and key staff.

Board Self-Evaluation Process

Chair Gorton said that Charley Ellis is scheduled to attend the July Board meeting to give a presentation on Board governance. He invited members to provide input to Ms. Whitmarsh on suggested topics for Mr. Ellis to address during his presentation. Ms. Whitmarsh received Board suggestions relating to addressing lessons learned from financial crisis and, based on that, any thoughts or changes to consider in investment decision making processes, Board oversight, or questions that should have been asked. Mr. Petit requested a broad discussion of Board governance. Mr. Hill suggested Mr. Ellis address the public nature of the Board and how governance processes fit within what the public expects and how to be effective given that environment. Mr. Nierenberg said he would like to have Mr. Ellis' reaction to staff's investment beliefs presentation, and his knowledge of lessons learned from what larger endowments are doing relating to hedging strategies over the past few years. Mr. Nierenberg provided a summary of Mr. Ellis background and experience.

Ms. Schurke asked if the Board had followed through on recommendations of best practices suggested by Seattle University (SU) during a past year's planning session. She recalled the SU presenter seemed to have a clear awareness of the public nature of the Board. Ms. Whitmarsh believed the Board had restructured its agenda based on that discussion, and would look back to see what others practices were adopted. Mr. Kaminski pointed out that one of the suggestions was for the Board to conduct an executive session at each Board meeting. Chair Gorton said the July meeting includes a Board self-evaluation session. Past practice has been for members to conduct an open conversation on any issue it wishes to discuss. The Administrative Committee opted to recommend the Board continue this practice.

Chair Gorton moved that the Board accept the Administrative Committee's recommendation for the self-evaluation process at its July meeting. Mr. Ragan seconded, and the motion carried unanimously.

Assistant Attorney General's Report

Mr. Dietrich updated members on the current status of the Lehman litigation being handled by the Coughlin Stoia law firm. The case was transferred from Thurston County Superior Court to the United States District Court for the Western District of Washington (Tacoma), and he expects it will be further transferred to the United States District Court for the Southern District of New York, given the federal statute allowing that litigation cases can be moved when bankruptcy is under consideration, which exists in this case. Mr. Dietrich said he fully anticipates that pre-trial arguments will be transferred to New York unless the bankruptcy is resolved beforehand. Afterward, the case will come back to Tacoma.

OTHER ITEMS

Mr. Petit reported that Internal Audit staff is undergoing a peer review. He met yesterday with Mr. David MacCabe who is conducting the review, and his preliminary verbal report is staff is doing a stand-up job. A final report should be available in a few months.

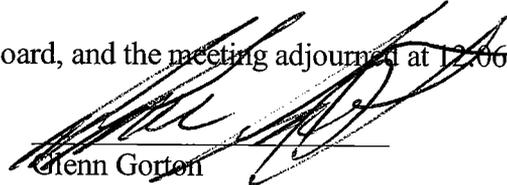
ANNUAL COMMITMENT PLAN UPDATES

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 WSIB or would result in private loss to the providers of the information. He said the executive session is expected to last about 10 minutes, at which time the Board would reconvene in open session.

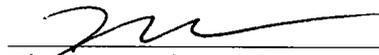
[The Board went into executive session at 11:21 a.m., and reconvened in open session at 12:06 p.m.]

There was no further business to come before the Board, and the meeting adjourned at 12:06 p.m.



Glenn Gorton
Chair

ATTEST



Theresa J. Whitmarsh
Acting Executive Director