

WASHINGTON STATE INVESTMENT BOARD
Board Meeting Minutes
February 18, 2010

The Washington State Investment Board met in open session at 9:45 a.m. in the boardroom at 2100 Evergreen Park Drive SW, Olympia, Washington.

Present: Pat McElligott, Chair
Treasurer Jim McIntire, Vice Chair
Steve Hill
George Masten
Richard Muhlebach
Bob Nakahara
David Nierenberg
Judi Owens
Mason Petit
Mike Ragan
Judy Schurke

Absent: Senator Lisa Brown
William Longbrake
Representative Sharon Tomiko Santos
Jeff Seely

Also Present: Theresa Whitmarsh, Executive Director
Gary Bruebaker, Chief Investment Officer
Liz Mendizabal, Public Affairs Director
Steve Lerch, Research 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

Steve Dietrich, Assistant Attorney General
Michael Humphrey, Courtland Partners
Dave Woolford, Capital Dynamics

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

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

OATH OF OFFICE – RICHARD MUHLEBACH

Chair McElligott administered the oath of office to Mr. Muhlebach as a nonvoting Board member for a three-year term effective January 1, 2010, until December 31, 2012.

ADOPTION OF THE JANUARY 21, 2010, MINUTES

Mr. Ragan moved to adopt the January 21, 2010, Board meeting minutes.

Mr. Petit seconded, and the motion carried unanimously.

PUBLIC COMMENT

There was no public comment.

COMMITTEE ASSIGNMENTS

Chair McElligott recommended the Board assign Mr. Muhlebach to the Private Markets Committee and Mr. Longbrake to the Audit Committee.

Mr. Masten moved the Board accept the Chair's recommended Committee assignments. Ms. Owens seconded, and the motion carried unanimously.

EXECUTIVE DIRECTOR'S REPORT

Ms. Whitmarsh provided her monthly report for February on Board governance, investments, public affairs, staffing, operations, and open and upcoming procurements. She reported priorities for the 2010 Strategic Plan include Board-level risk management and reporting; reviewing defined contribution and Deferred Compensation Program (DCP) investment options with the Department of Retirement Systems; developing Labor and Industries' (L&I) funds investment beliefs; implementing 2010 and developing 2011 asset class investment plans; manager procurement activities; and staff resource planning. Ms. Whitmarsh announced the July Board meeting will be held at the Heathman Lodge in Vancouver, Washington.

Ms. Whitmarsh said the Audit Committee meets on March 2. The March Public Markets, Private Markets, Administrative Committee, and Board meetings were cancelled due to lack of business. There is no update on the Legislature's consideration of a staff furlough bill. She said the WSIB should be able to manage any such mandate through cost savings. The Governor has signed three bills relating to freezes on contracting, purchasing, travel, salaries, and hiring. The WSIB was exempted from freezes on hiring, contracting, equipment purchases, and travel last year (as a revenue generating agency), and has sent a letter to confirm that exemption will carry into this year.

FIXED INCOME ANNUAL REPORT

Mr. Kennett presented a review of the fixed income portfolios for 2009, and his 2010 outlook. He said, despite the economic difficulties in the U.S., the WSIB fixed income group had its best performing year ever, returning 17.3 percent for the retirement funds, or more than \$1 billion above the index return.

Mr. Kennett reviewed U.S. economic, inflation, unemployment, housing, and credit data; and non-U.S. economic activities throughout 2009. He said fixed income (excluding treasuries) and equities had excellent returns in 2009 because many assets were priced for a depression at the end of 2008. He reviewed 10-year treasury yields, investment grade credit spreads, interest rate and yield curve changes, and returns for the Barclays Aggregate and Universal indices.

For 2010, Mr. Kennett believes the economy will remain fragile, with the impact of the financial crisis lasting many years. He commented on the budget deficit, interest rates, federal stimulus programs, unemployment, real estate, credit, and consumer issues.

Mr. Kennett anticipates a gradual recovery going forward, with developed markets growing slower than emerging markets. He cautioned that not all emerging markets are alike—about half present good, but different, investment opportunities. Mr. Nierenberg commented there are creative ways to participate in emerging markets within Public Equity that are not as pricey.

Mr. Kennett listed the 2010 portfolio implications for the fixed income group are to: shorten duration; underweight treasuries; overweight emerging markets; wait for widening before purchasing mortgages; maintain credit exposure; and add floating rate securities. He said liquidity remains important.

The fixed income portfolios held \$24.5 billion in assets at year end 2009, approximately 46 percent in the retirement fund, 40 percent in L&I funds, and the remaining percentage spread among Permanent Funds, the Intermediate Bond Fund, Savings Pool, Guaranteed Education Tuition, and Developmental Disabilities Endowment Fund. He said the fixed income sector allocation is comprised of over 50 percent credit investments.

The fixed income retirement fund goal is to meet or exceed performance of the Lehman Universal Index and provide diversification. Mr. Kennett summarized WSIB's holdings, returns, and country and industry allocations compared to the Universal, which resulted in outperformance of 871 basis points (bps).

The L&I funds' goals are to maintain solvency, rate stability, and sufficient assets to pay liabilities. Staff manages assets to the liabilities, places importance on income, and minimizes cash flow uncertainty. Mr. Kennett said all funds outperformed in 2009 for all periods, except the Supplemental Pension Fund.

Mr. Kennett reported the Permanent Funds also outperformed in 2009.

Mr. Nierenberg complimented Mr. Kennett and the fixed income team on the tremendous performance. He suggested the Board should look for ways to do a global mandate within in Public Equity if the fiscal situation changes, and possibly shift staff and redeploy assets to support that.

[The Board took a brief recess at 10:57 a.m., and reconvened in open session at 11:13 a.m.]

ADMINISTRATIVE COMMITTEE REPORT

Chair McElligott said the Administrative Committee met just prior to today's Board meeting and there was nothing to report.

PRIVATE MARKETS COMMITTEE REPORT

The Private Markets Committee met on February 4, 2010.

Private Equity Investment Recommendation – CDH Fund IV, L.P.

Mr. Masten moved the Board invest up to \$25 million, plus fees and expenses, in CDH Fund IV, L.P., subject to continuing due diligence and final negotiation of terms and conditions. Vice Chair McIntire seconded the motion.

Mr. Masten reported the fund will principally invest in Chinese companies that sell their products in China. The team has a long tenure. The average IRR on the first three fund investments is

36 percent: 94 percent from the first fund, 47 percent from the second, and the third has not existed long enough to produce big returns. Mr. Masten said this is a great investment opportunity. The recommendation is for \$25 million because that is the maximum the WSIB could get from the general partner, but there is an opportunity for greater investments going forward.

The above motion carried unanimously.

Private Equity Investment Recommendation – Oaktree Opportunities Funds VIII and VIIIb, L.P.

Mr. Masten moved the Board transfer up to \$125 million of the WSIB’s commitment in Oaktree Opportunities Fund VIII to Oaktree Opportunities Fund VIIIb, subject to continuing due diligence and final negotiation of terms and conditions. Mr. Hill seconded the motion.

Mr. Masten reported this recommendation does not increase the obligation to Oaktree for investment. Oaktree believes there are better opportunities to invest the \$125 million going forward, but will invest if opportunities arise sooner. Mr. Masten said it appears to be a great opportunity to spread out and get good returns.

The above motion carried unanimously.

Real Assets – Real Estate Investment Program Policy 2.10.600 Revision

Mr. Masten moved the Board approve the proposed revisions to the Real Estate Investment Program Policy 2.10.600. Vice Chair McIntire seconded the motion.

Mr. Masten reported the proposed policy revision implements changes discussed at the Real Estate Annual Planning session: (1) to set the Board’s benchmark for real estate to be an 8 percent annual investment return over a rolling ten year period, (2) to retain the National Council of Real Estate Investment Fiduciaries (NCREIF) Property Index to compare against WSIB returns, and (3) add policy language “that individual investments (defined as equity investment plus any recourse debt) within partnerships approved by the Board where staff has approval or veto rights over such investments will be limited to no more than 20 percent of the total commitment from which the investment is being made without the written approval of the Chief Investment Officer.”

The above motion carried unanimously.

2009 WSIB ANNUAL REPORT

Chair McElligott moved the Board approve the 2009 WSIB Annual Report. Mr. Ragan seconded, and the motion carried unanimously.

[The Board took a brief recess at 11:18 a.m., and reconvened in open session at 11:37 a.m.]
[Vice Chair McIntire was not in attendance 11:37 a.m.]

QUARTERLY DISCUSSION OF MARKETS

Portfolio Discussion

Mr. Bruebaker reported equity markets are up 66.63 percent since March 2009. The Commingled Trust Fund (CTF) is up 3.34 percent for the three-month period ended December 31, 2009. He

compared the CTF's quarterly performance against the Implementation Value Added benchmark, noting that private markets lag when public markets outperform. Within allocation decisions, performance was helped by 5 bps due to underweighting Tangible Assets, and the Overlay program helped by 11 bps. Performance was hurt by 5 bps due to underweighting Private Equity, and by 17 and 7 bps by overweighting in Real Estate and cash, respectively. Within manager decisions, performance was hurt by 213 and 5 bps in Private and Global equities, respectively; and helped by 21 bps in both Fixed Income and Real Estate, and by 4 bps in Tangible Assets.

Public Equity

Mr. Paroian reported public equity markets had an unexpectedly good year, having bounced back quickly from the financial crisis. For the year, U.S. markets were up over 28 percent, all-country world index was up 37 percent. Non-U.S. and emerging markets were up over 43 and 82, respectively. Country rebounds were led by commodity producers, but Japan and frontier markets lagged. Within sectors, materials and consumer discretionary investments were up. Mr. Paroian reported that WSIB equity managers are focusing on what they can predict and understand. He reported the Public Equity portfolio was somewhat overweight in U.S. during the fourth quarter 2009 and first quarter 2010; and the U.S. lagged for the year but has shown recent improvement. Since year end, so far in 2010 the markets are down about 3.5 percent. The portfolio is still underweight emerging markets, but staff is working to finalize manager contracts to correct that situation.

Real Estate

Mr. Draper reported the bright spot in Real Estate for the third quarter 2009 is the slowing rate of value decline in the market. He believes staff has a good handle on where future issues may remain within the portfolio. The vast majority of the portfolio is performing well on a relative basis, with excellent partners working on the WSIB's behalf. No material new issues came up in the third quarter, with challenges still remaining in structured finance and in some fund investments that applied inappropriate leverage.

He said returns on REOC investments exceeded fund investment returns over a rolling one-year time period by 24 percent as of the third quarter. The overall Real Estate portfolio is generating income around 6 percent on an annualized basis. Mr. Draper said the portfolio has benefitted from diversification of geography and nontraditional property types.

Private Equity

Mr. Ruggels reported private equity returns are continuing to recover. During the third quarter 2009, the Private Equity portfolio had its second consecutive positive quarter, returning 10.6 percent. He also expects a positive fourth quarter return. He said cash flow activity and distributions are increasing, and the ability of private equity firms to borrow has improved very recently, creating a lot of competition for deals. Mr. Ruggels commented that the IPO market for private equity backed companies has pulled back a bit recently.

Public Equity (continued)

In response to Mr. Hill's request, Mr. Paroian reported on Plans 3 and DCP performance. Most options are passive and long-term performance remains close to the benchmark indexes for each fund. Within the active options, Alliance Bernstein continues to outperform their index, but DCP options have experienced some challenges—staff is closely monitoring the Active Core and International Stock options. A review of investment options for these funds is planned during 2010, and staff will ensure that performance for Plan 3 and DCP options is included in all quarterly reports

to the Board going forward.

Real Estate

Mr. Humphrey reported on real estate market conditions. He reviewed a timeline of the credit market crisis since March 2008. He noted the real estate bubble is deflating, with commercial real estate expected to take longer than residential. Courtland is trying to determine the “new norm” in market conditions for how to invest going forward. In particular, they are examining the impacts of the federal deficit and automotive production (and its affect on employment) on inflation and the demand for real estate.

Mr. Humphrey reviewed the increased foreclosure activity through the third quarter 2009, particularly in former growth markets of Southern California, Las Vegas, Phoenix, and Florida. He noted significant value reduction and distressed markets create long-term investment opportunities. He reviewed mortgage resets, home pricing, and delinquency rates; and NCREIF all property market conditions from 1978 forward. Mr. Humphrey reviewed the significant U.S. net capital flow activity during the 2001-2007 periods.

Private Equity

Mr. Woolford reported on the current private equity environment. He said credit availability is improving, valuations have risen, and deal flow has experienced a substantial increase; there has been interesting activities within mezzanines and co-investments. Fundraising in 2009 was down up to 65 percent from the previous two years. He expects fundraising will remain difficult into 2010. There is ongoing discussion of the International Limited Partner Association principles, and general partners are offering a variety of terms. Mr. Woolford commented on IPOs, exit pricing, venture capital activity, distressed markets and secondaries.

OTHER ITEMS

There was no further business to come before the Board and the meeting adjourned at 12:38 p.m.



Patrick McElligott
Chair

ATTEST

Theresa J. Whitmarsh
Executive Director