WASHINGTON STATE INVESTMENT BOARD
Board Meeting Minutes
April 15, 2010

The Washington State Investment Board met in open session at 9:59 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 Representative Sharon Tomiko Santos Jeff Seely
Absent:	Senator Lisa Brown William Longbrake Judy Schurke
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 Victor Moore Jack Gray George Roberts, KKR Mike Michelson, KKR Dan McLaughlin, KKR

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

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

ADOPTION OF THE FEBRUARY 18, 2010, MINUTES

> **Mr. Masten moved to adopt the February 18, 2010, Board meeting minutes. Chair McElligott seconded, and the motion carried unanimously.**

PUBLIC COMMENT

There was no public comment.

EXECUTIVE DIRECTOR SIX MONTH EVALUATION

Chair McElligott said the Administrative Committee conducted the Executive Director's evaluation in executive session. Ms. Whitmarsh received excellent reviews from Board members and staff. The Board believes it made an excellent selection in appointing Ms. Whitmarsh as Executive Director. Chair McElligott thanked Ms. Whitmarsh for her efforts.

> **Chair McElligott moved the Board accept the Executive Director's evaluation as written. Mr. Ragan seconded, and the motion carried unanimously.**

KKR ANNUAL REPORT

Mr. Roberts said the relationship between KKR and WSIB began 29 years ago with a $10 million private equity commitment.

He commented on the current economic conditions including bank issues, federal government actions, business cutbacks, and unemployment.

KKR manages $50 billion in assets, mostly in the private equity asset class. He said there is a lot of misinformation about private equity, which is not without risk. Private equity investments are long-term, illiquid, and cyclical in nature. It usually takes 5-7 years to get return on properly-placed investments. KKR seeks out high quality companies it can improve to create value. He noted that KKR pays a lot of attention to alignment of interests and fees. It has committed $6.5 billion in its own investments—more than Washington and Oregon combined. Mr. Roberts said KKR's terms are substantially better than those of competitor firms.

Mr. Roberts commented on KKR as a public company, which is building its business in private equity, debt investments, and capital markets. KKR is adapting as the world changes to grow its business and stay competitive.

Mr. Roberts commented on improvement in the financial markets, but lagging economy. He does not anticipate huge inflation, but believes unemployment will continue for awhile. He said Europe is lagging the U.S. economy, but there is growth in India and China. He believes private equity will evolve as the economy and credit markets recover. KKR is focused on finding the few good deals available and managing its portfolio. It is cognizant that retirees' pension and benefits are somewhat dependent on its investment performance, and KKR works hard to get good results.

Mr. Michelson presented information on KKR's differentiated approach, portfolio company performance, 2009-2010 investments and liquidity events, updated KKR investment performance for WSIB, and 2010 outlook.

Since 1982 WSIB has invested $6.1 billion with KKR. KKR has returned approximately $7.7 billion in realized proceeds and created $4.8 billion in profits for the WSIB. Investments have generated at 19 percent net internal rate of return (IRR) and a 1.74x net multiple on invested equity capital for the WSIB.

Mr. Michelson reviewed KKR's historical private equity experience. They have conducted over 170 transactions across 25 industries within 14 investment funds. The current portfolio includes 54 companies. He discussed KKR's team, investment experience, global presence, industry expertise, and proprietary investment sourcing. He outlined the resources KKR has built into its firm to create value, and described KKR Capstone's operating approach and Capital Markets global team.

Mr. Michelson provided an update on portfolio performance. He said about 85 percent of North American companies increased valuations in 2009. The Europe economy is a bit slower than North America, with some industries cyclical in nature. Asia showed very strong performance, particularly in the latter half of 2009. For 2010, KKR's approach is to focus on productivity, cost containment, and refinancing to strengthen balance sheets. He briefed members on new investments and liquidity events for 2009 and 2010.

Mr. Michelson compared KKR's performance on WSIB investments against the S&P 500 and Russell 3000 returns. He reviewed historical performance of each KKR fund. In 2009, the value of WSIB's investments in the KKR funds has increased by more than $700 million.

Mr. Michelson said prior experience indicates that market dislocations create opportunities. KKR is seeing an increase in attractive opportunities, credit markets are reopening, corporate activity is increasing, and there are several types of investment opportunities.

KKR responded to Board member questions on company growth patterns going forward, impacts resulting from healthcare reform, credit markets, financial reform, refinancing, and unemployment.

Chair McElligott shared his appreciation for the longstanding relationship between the WSIB and KKR.

PRIVATE MARKETS COMMITTEE REPORT

Mr. Masten reported the Private Markets Committee met on April 8, 2010, and discussed one investment recommendation and a revision to the Private Equity Investing Policy.

Menlo Ventures XI, L.P.

> **Mr. Masten moved that the Board invest up to $200 million in Menlo Ventures XI, L.P, not to exceed 25 percent of the fund's commitments, plus fees and expenses, subject to continuing due diligence and final negotiation of terms and conditions. Mr. Hill seconded the motion.**

Mr. Masten said the fund, with a target size of $800 million, will invest in companies with the potential for significant growth, focusing on technology sectors in the U.S., including communications, consumer products, Internet, computer storage, software, mobile applications, and financial services. The WSIB has invested with Menlo Ventures since 1981. He said the recommendation is based, in part, on Menlo's strong franchise; talented, experienced team; long-term performance; proven, proactive strategy; focus; and fit in the WSIB's private equity portfolio. The proposed investment is consistent with the private equity annual plan and model portfolio approved by the Board in January 2010. Mr. Masten said the Board materials lay out the historical net IRR on

Menlo investments. He believes WSIB's investment would be a great opportunity to earn returns in the market.

Mr. Nierenberg said he had raised three questions about this investment recommendation prior to the Private Markets Committee meeting, and received satisfactory answers to two and is confident the third will also be answered. However, he pointed out the questions provoked a fair amount of discussion on the general partners' workload plans and updated performance information on Fund IX. Further, he hopes that Capital Dynamics can provide analysis of changing IPO markets and the implication for the venture capital industry going forward. Mr. Masten shared his appreciation for Mr. Nierenberg raising his concerns. Mr. Hill concurred. Representative Santos thanked Mr. Nierenberg for raising his concerns. She regrets not being available to attend the Committee meeting and join in the conversation surrounding this investment.

The above motion carried unanimously, with Representative Santos abstaining.

Private Equity Investing Policy 2.10.700 Revision

Mr. Masten moved that the Board approve the proposed revisions to the Private Equity Investing Policy 2.10.700. Chair McElligott seconded the motion.

Mr. Masten said the policy revision reflects the changes to the private equity program benchmark discussed at the Private Equity Annual Planning session and approved by the Board in January 2010. The retroactive application of the new benchmark will allow for meaningful performance comparisons to WSIB's peers and for the analysis in the annual Cost Effectiveness Measurement study.

The above motion carried unanimously.

[The Board took a brief recess at 11:37 a.m., and reconvened in open session at 11:57 a.m.]

MARKET DYSFUNCTIONALITY

Mr. Gray presented information on eight market dysfunctionalities. He provided background on how market studies evolved, institutions' affect on markets, who is involved in the studies, and when the work began. The aim is to do research that will result in policies with recommendations for improvements; thus far, a number of papers have been issued on what can be done.

Mr. Gray described Dysfunction 1 as "momentum investing," or buying something that is going up, hanging onto it, and then getting out. This can deny capital to companies with good fundamentals that aren't attractive to the market, which is a misallocation of capital that lowers economic growth. It can create private gain at public cost. Potential solutions include regulation and cooperation among funds.

Dysfunction 2 is "excessive active management." Studies have revealed that investors engage in active management for appropriate reasons, such as when markets are inefficient, but also more inappropriately due to behavioral biases and poor reasoning. Dysfunction 3 is "competition doesn't work well." Competition should push fees down, but managers tend to compete in areas other than on fees because manager quality is difficult to observe.

Dysfunction 4 is "plethora of agents." What are you getting in exchange for what agents are doing and are they doing what is in your best interest? Mr. Gray said experts are as vulnerable as anyone else to eternal myths, fables, and slogans; or a little "hook of truth" (e.g., real estate never goes down). Dysfunction 5 is "capital sans power." Mr. Gray stated the financial services industry, rather than owners of capital (such as pension plans), is in the stronger position to determine products, services, and fees. While the financial services industry does facilitate wealth creation, its power also enables it to behave in ways that benefit the industry more than capital owners.

Dysfunction 6 is "loss of trust." This loss of trust can occur when investors have an overly negative long-term view of asset classes that have performed poorly in the recent past. Boards can address this dysfunction by ensuring that investment and asset allocation decisions include wide-ranging discussions of historical performance and potential future scenarios. Mr. Gray also noted the loss of confidence in institutions generally that occurs when market mechanisms do not function well, such as in the areas of executive compensation and mergers and acquisitions. This loss of trust causes investors to have difficulty in distinguishing between value-creating and value-destroying activities.

Dysfunction 7 is "failed models, theories, and process." Mr. Gray said that modern economic theory was tested during the recent market crisis. Theories are deeply flawed. He described comforting and discomforting processes, the latter of which is what is done in most investment situations.

Mr. Gray described available economic market studies for further consideration. Finally, he said that Dysfunction 8 deals with political and moral values.

Treasurer McIntire asked Mr. Gray to comment on vulnerability to myths and how it relates to relationships, as there is a lot of emphasis on the importance of general partner and manager relationships. Mr. Gray said one measure of the importance of a relationship is whether it generates an exchange of value from the general partner or manager to the investor. It is critical to be able to trust those with whom you do business, but it can also make you more vulnerable.

EXECUTIVE DIRECTOR'S REPORT
Ms. Whitmarsh introduced Victor Moore, who will begin work as the WSIB's Chief Operating Officer/Chief Financial Officer on April 16.

CAPITAL MARKET ASSUMPTIONS
Ms. Will described the white paper included in the Board materials explains how the proposed capital market assumptions were developed. While modeling can be faulty, a lot of information can be gained from it. She described typically not much change is anticipated year-to-year for long-term assumptions. The last two years have had more changes than most. 2008's market decline caused staff to raise some of the return assumptions in last year's number but, with the recovery in 2009, staff is reducing the equity assumptions to be closer to long-term norms for the next fifteen years. The proposed changes are as follows:

	Mean Return	Standard Deviation
TIPS	4.50	6.00
Fixed Income	4.50	5.00
Tangible Assets	6.50	8.00
Real Estate	8.00	15.00
Global Equity	8.90	17.30
U.S. Equity	8.75	17.00

International Equity	9.00	19.00
Private Equity	11.75	28.00
Cash	3.00	2.00
Inflation	2.50	1.75

Correlation	TIPS	Fixed Income	Tangible Assets	Real Estate	Global Equity	U.S. Equity	Int'l Equity	Private Equity	Cash
TIPS	1.00								
Fixed Income	0.40	1.00							
Tangible Assets	0.35	0.30	1.00						
Real Estate	0.10	0.20	0.40	1.00					
Global Equity	0.00	0.20	0.10	0.43	1.00				
U.S. Equity	0.00	0.30	0.00	0.45	0.85	1.00			
International Equity	0.00	0.15	0.00	0.40	0.90	0.80	1.00		
Private Equity	0.00	0.20	0.10	0.40	0.80	0.75	0.70	1.00	
Cash	0.25	0.20	0.20	0.15	0.00	0.05	-0.10	0.00	1.00

Ms. Will said the WSIB assumptions are used in State Actuary modeling, by the Guaranteed Education Tuition Program to price college tuition units, and will be used by staff for the Permanent Funds asset allocation analysis.

Treasurer McIntire noted that staff's recommendation is lower than the consultant average in some cases. Ms. Will commented on the consultant pool results, and how she dealt with those she perceived as outliers. Mr. Seely complimented the white paper write-up. He asked Ms. Will to comment on the recommended changes within private and U.S. equity. Mr. Nierenberg noted that modeling does not necessarily reflect what really happens in the world. Ms. Will said the modeling software is beginning to pick-up skew and kurtosis, and building that information into portfolio assumptions. Treasurer McIntire asked Ms. Will to provide data on the one standard deviation range.

Mr. Bruebaker pointed out the change in capital markets makes the median return over a 15-year period 7.7 percent. Last year the projected median return was 7.98 percent. Discussion ensued around the range of potential returns. The Legislature wants the WSIB to earn 8 percent, and it will continue to strive to do so.

Ms. Will commented on the blend of science and art in modeling financial information. She believes modeling provides a good picture of what could potentially happen and risks.

> **Treasurer McIntire moved to adopt the 2010 WSIB capital market return, risk, and correlation assumptions as contained in the Board materials. Mr. Masten seconded, and the motion carried unanimously.**

AUDIT COMMITTEE REPORT

Mr. Hill reported the Audit Committee met on March 2. It received a report on investment compliance, which noted there were no outstanding compliance issues, and included plans for 2010. It also received an Enterprise Risk Management update, including the program's evolution, structure and framework, team activities and tools; the quantitative risk program; and 2010 planned activities.

The Committee also received the annual Daily Valued Funds report, which is required by Board policy. There was one immaterial error occurring during 2009. This involved a security in the Bond Fund that was entered incorrectly, causing it to accrue one day less of interest ($1,006.94) each day from February 3, 2009, to August 1, 2009. There was no impact to the closing unit price.

Mr. Hill said the Committee heard the results of the Private Equity internal audit. The overall audit assessment was good. There was one audit recommendation that the WSIB formalize a contact and referral policy or process with regard to investment opportunities that come to the WSIB. Management said it would document current practice and come back to the June Audit Committee meeting with a description of best practices for consideration of the Committee.

The Committee also received an update on outstanding audit recommendations, which included a discussion with JPMorgan (JPM) representatives who updated members on outstanding performance issues and access for our internal auditor to JPM documentation for audit purposes. JPM was directed by the Committee to resolve issues relating to internal audit access by June, or be prepared to come back and explain to the Committee why they could not comply.

Audit Committee Charter 1.00.130 Revision

Mr. Hill said the Committee had also planned to discuss a number of issues relating to nonvoting Board member selection processes, currently in the Audit Committee Charter, including: (1) whether the Audit Committee is the appropriate Committee for such a discussion, (2) the role of nonvoting Board members, (3) desirable qualifications, (4) nomination and selection processes, and (5) appropriate length of time nonvoting members should serve on the Board. After discussion, the Committee concluded that fiduciary counsel's memos and legislation clearly state that voting members select nonvoting members; therefore, the Committee is proposing to move the function of nonvoting Board member nominations from Audit to the Administrative Committee and for that Committee to select which matters to address.

> **Mr. Hill moved the Board approve the proposed revisions to the Audit Committee Charter 1.00.130. Chair McElligott seconded, and the motion carried unanimously.**

ADMINISTRATIVE COMMITTEE REPORT

Sudan Resolution

A revision to the proposed Sudan Resolution was distributed.

> **Chair McElligott moved the Board adopt the WSIB Resolution on Sudan Investment, as amended at the Administrative Committee meeting. Mr. Masten seconded the motion.**

Treasurer McIntire said he presented WSIB's Iran and Sudan Resolutions at a national Treasurer's meeting. The WSIB's approach was well received, and he commended staff's work.

> **The above motion carried unanimously.**

Administrative Committee Charter 1.00.120 Revision

Chair McElligott moved the Board approve the proposed revisions to the Administrative Committee Charter 1.00.120. Mr. Masten seconded the motion.

Chair McElligott spoke in support of the recommended Administrative Committee Charter change, resulting from Audit Committee discussions regarding nonvoting Board member processes.

The above motion carried unanimously.

OTHER ITEMS
There was no further business to come before the Board and the meeting adjourned at 1:25 p.m.

Patrick McElligott
Chair

ATTEST

Theresa J. Whitmarsh
Executive Director