WASHINGTON STATE INVESTMENT BOARD
Board Meeting Minutes
May 20, 2010

The Washington State Investment Board met in open session at 9:31 a.m. in the boardroom at 2100 Evergreen Park Drive SW, Olympia, Washington.

Present:	Pat McElligott, Chair Treasurer Jim McIntire, Vice Chair William Longbrake George Masten Richard Muhlebach Bob Nakahara David Nierenberg Judi Owens Mason Petit Mike Ragan Judy Schurke Jeff Seely
Absent:	Senator Lisa Brown Steve Hill Representative Sharon Tomiko Santos
Also Present:	Theresa Whitmarsh, Executive Director Gary Bruebaker, Chief Investment Officer Victor Moore, Chief Operating 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 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 took roll call.

OATH OF OFFICE – WILLIAM LONGBRAKE
Chair McElligott administered the oath of office to Mr. Longbrake as a nonvoting Board member for a three-year term effective January 1, 2010, until December 31, 2012.

ADOPTION OF THE APRIL 15, 2010, MINUTES

Treasurer McIntire moved to adopt the April 15, 2010, Board meeting minutes. Mr. Ragan seconded, and the motion carried unanimously.

PUBLIC COMMENT

There was no public comment.

PRIVATE MARKETS COMMITTEE REPORT

Mr. Masten reported the Private Markets Committee met on May 6, 2010, to consider one investment recommendation and participate in an educational session by Capital Dynamics on value creation in private equity.

Littlejohn Fund IV, L.P.

Mr. Masten moved the Board invest up to $150 million in Littlejohn Fund IV, L.P, plus fees and expenses, subject to continuing due diligence and final negotiation of terms and conditions. Treasurer McIntire seconded the motion.

Mr. Masten said the fund has a target size of $1.25 billion, and will primarily make control investments in middle-market companies that are under-performing their potential and can benefit from Littlejohn's operational and strategic help. Littlejohn would be a new general partner relationship for the WSIB. The recommendation is based, in part, on Littlejohn's cohesive and experienced investment team, strong track record, attractive target market, and fit in the WSIB's private equity portfolio. He said the investment is in line with the private equity annual plan approved by the Board. The net internal rate of return (IRR) for the previous funds is 15 percent and Fund III has a 23 percent net IRR.

The above motion carried unanimously.

REAL ESTATE RISK EDUCATION SESSION

Mr. Draper provided an overview of how the Real Assets team views, assesses, and mitigates risks in the real estate portfolio. He said an additional educational session on Infrastructure would be presented this fall.

Mr. Draper said the portfolio's primary goal is to generate a stable income stream, with a secondary goal to generate appreciation. He reviewed the WSIB investment beliefs that only some risk can be defined and measured at the present time, risk must be considered at portfolio level, the WSIB should be compensated for the risk it takes, and risk is managed at both the portfolio and partnership levels. Mr. Draper said the team's approach is to identify trends and understand risk elements. He emphasized their focus on people, strategy, and structure—in that order. He noted the WSIB investment approach differs from its peers. He emphasized the keys to success are a long-term perspective, partner selection, and program consistency.

Mr. Draper explained how each partnership is reviewed based on a defined set of risk categories during underwriting and oversight, and these risks are also reviewed an ongoing basis. He noted the potential for risk interactions ("domino effect") is carefully considered and monitored.

Mr. Draper provided a detailed description of each of the risk categories, including: governance, market, development, exit, political, foreign, structure, property type, operating, entitlement, marketing/leasing, management, leverage, key person, concentration, and risks specific to individual situations.

Mr. Seely said he found the list of risk categories to be thorough, but almost too broad. He questioned whether staff had considered framing the risk universe differently, and asked if its structure is similar to peer organizations. Mr. Draper replied a simpler way to consider the categories is to group them by people, strategy, and structure. The risk categories are not equally weighted for all situations.

A discussion ensued relating to global investing and political risk. Mr. Draper said, to mitigate political risk, it is important to get governance risks dealt with up front. Ongoing conversations occur within the Real Assets team to discuss global issues, including discussions about various countries as potential investment targets. Additionally, market risk is extensively discussed as it is often the "first domino" to fall. Staff takes a forward-looking approach for a 10- to 20-year investment timeframe.

Treasurer McIntire asked if there is rationale for trying to hedge against any portfolio concentration risk. Mr. Draper said staff began taking steps to navigate such risks five years ago and developed several scenarios to deal with situations that may arise, including leverage issues.

[Treasurer McIntire left at 10:40 a.m.]

Mr. Muhlebach asked how entrepreneurial risk is managed within real estate operating companies (REOCs), as he feels it could be a primary risk for those investments. Mr. Draper agreed it is a critical factor. He described the intermediary approach WSIB uses, as well as the extensive efforts that are made to have succession planning within the companies in which the WSIB invests. He believes much of this can also be managed through good governance.

Mr. Draper described the risks previously discussed are regularly assessed and assumptions updated, then overlaid in a matrix report to provide a portfolio level risk assessment in the form of a heat map. Then, materiality of each risk for each partnership is also considered, which allows for a qualitative assessment of the relative risk level of each partnership. Assessments of the likelihood, impact, and frequency of risks within each of the categories are then applied. The result is a representation of WSIB's investment thesis—the portfolio risk chart. The chart provides a visual representation of the portfolio level risk profile which lays out the potential dollar and portfolio impact, and likelihood and speed of a material negative event occurring. The impacts are further categorized by people, structure, and strategy orientation. Staff uses the chart as a tool to proactively manage risk.

A discussion ensued on the differences between REOC versus fund risks. Mr. Nierenberg pointed out the risk chart reinforces the decision to accept and manage key person risk within REOCs. Mr. Seely concurred. He said REOCs demonstrate there are risks we cannot control, and feels that consideration should be given to adding external experts as foreign investment recommendations are considered.

Mr. Draper said that risk is managed through partnership selection, portfolio knowledge, and diversification by geography, property type, partners, strategy, demographics, and property life cycle. He provided an overview of the real estate geographic breakdown within the U.S., Europe, Asia, Australia/Pacific, and Latin America. Currently, the portfolio is two-thirds invested in the U.S., but he expects that to shift more to non-domestic investments over time. A discussion ensued relating to the current political risk in Mexico, and the ability to reduce or hedge portfolio exposure. Mr. Draper relayed that staff has discussed the issue and decreased the WSIB's equity exposure since December. He provided breakdowns of real estate property type, partnership structure, and by partner.

[Ms. Schurke left at 11:24 a.m.]

Mr. Draper said that risk is managed by focusing on current income, paying attention to relative value, establishing good governance, and maintaining alignment of interests. He described that real estate cannot use a model portfolio like private equity due to relative complexity, and the variability of geographic and property type parameters. He concluded by saying that staff spends an exceptional amount of its time managing risk by focusing on people, strategy, and structure with a long-term perspective.

Mr. Nierenberg encouraged staff and members to think about what the geographic portfolio might be in five to ten years, and consider whether it is investing adequately as far as staff time and relationship building to find partners who share the WSIB's vision in order to build long-term value.

ADMINISTRATIVE COMMITTEE REPORT
Nonvoting Board Member Qualifications
Chair McElligott said the Administrative Committee chose to form a Committee of three members to look at the entire nonvoting Board member process. Mr. Masten will chair the Committee and, with assistance from Mr. Hill, Treasurer McIntire, and staff, bring back a recommendation in June.

PUBLIC MARKETS COMMITTEE REPORT
Mr. Ragan reported the Public Markets Committee met on May 4, 2010, to participate in an education session on global investing. Consistent with the 2010 public equity annual plan, active global equity is the primary focus for 2010 and 2011, as the active global equity search is conducted and implemented. William Sterling, founder and Chief Investment Officer of Trilogy Global Advisors, provided a global equity practitioner's perspective on global equity investing. Trilogy is one of the global equity managers in the Commingled Trust Fund's (CTF's) Innovation Portfolio.

The presentation focused on the following main points of the presentation:

- globalization is likely to accelerate in coming years;
- active global equity managers have outperformed passive and outperformed combinations of separate U.S. and non-U.S. managers;
- regional and country factors have waned as key drivers of global performance and the importance of stock selection has increased; and
- global active managers have several advantages over regional specialists.

The presenter shared his belief that successful equity investment philosophies for the next several decades should be based on two assumptions: (1) the pace of technological change will accelerate and (2) the forces of globalization will intensify.

[The Board took a brief recess at 11:40 a.m. and reconvened in open session at 12:07 p.m.]

[Chair McElligott left at 12:07 p.m. Mr. Masten served as Acting Chair.]

EXECUTIVE DIRECTOR'S REPORT

Ms. Whitmarsh provided her monthly report for May on Board governance, investments, public affairs, staffing, operations, and open and upcoming procurements. The Private Markets Committee will meet June 3 to interview three finalist private equity consultant candidates. Staff decided to split the front office and back office responsibilities. Staff is still reviewing candidates for the back office portion. The Public Markets Committee cancelled its June meeting due to lack of business. Ms. Whitmarsh said the July Board agenda is finalized—the meeting theme is global investing and what that means for the WSIB. A concentration analysis will be presented at the June Board meeting, which will lead into what staff hopes to be robust risk discussions in July. She reported staff will present a status report to the Employee Retirement Benefits Board next week on the review of investment options for the Deferred Compensation Program (DCP) and Plan 3s. Staff continues to work on investment beliefs for the Labor and Industries' (L&I) funds.

QUARTERLY DISCUSSION OF MARKETS

Portfolio Discussion

Mr. Bruebaker reported it has been a good quarter, despite the fact the financial markets are still not good. The CTF was up 3.33 percent for the quarter, up 24.72 for the one-year, and up 8.51 percent since inception. The equity markets are up 64 percent since the market low on March 9, 2009, but are down 10 percent since the recent market high on April 23, 2010. He noted the Implementation Value Added benchmark involves a lot of factors that are not shown in the Board packet materials. For the quarter, Tangible Assets underperformed by 3 basis points (bps), global equity managers underperformed by 12 bps, and real estate managers underperformed by 20 basis points. Mr. Bruebaker said this was offset by the internally managed fixed income program, which outperformed by 11 bps for the quarter. Private equity was up 27 bps. Asset allocation decisions helped by 7 bps overall, but was hurt somewhat by fixed income, global equity, and the cash allocation, which were offset by the overlay program which helped by 15 bps and an underweighting to real estate which helped by 2 bps.

<u>Fixed Income</u>

Mr. Kennett reported that, during the first quarter of 2010, the retirement fund's fixed income portfolio returned 2.52 percent versus 2.04 percent for the Barclays Capital Universal Index. The returns of the major sectors of the index were: 2.86 percent for credit, 2.14 percent for securitized, and 1.10 percent for governments. The primary reason for the fund's outperformance was an overweight in credit and outperformance within credit. At the end of the quarter, credit totaled 55 percent of the fund versus 32 percent for the index. The securitized sector also contributed to the outperformance. The fund's securitized sector had returns of 2.72 percent. The fund's government securities underperformed the index.

The three large L&I funds returned between 35 and 11 bps less than their respective Comparable Market Indices. The differences were due to the funds underweight in credit, the underweight of financials within credit, and the short duration of their government securities.

The Bond Fund, an option for the DCP and Plan 3s, returned 2.29 percent for the quarter, 6 bps less the Barclays Capital intermediate credit index. The main reason for the underperformance was the fund's underweight of financials.

The five Permanent Funds that are actively managed have outperformed for all reported time periods.

Mr. Kennett noted that, since the end of the quarter, the markets have turned around due to the European debt problems. The fixed income markets have seen increased volatility and a flight to quality.

Public Equity

Mr. Paroian reported the public markets continued to bounce back in the first quarter. Global indices were up 3.6 to 3.8 percent depending on the index, emerging markets were up about 2.7 percent, non-U.S. was up about 2 percent, and the U.S. was up about 6 percent.

Things have changed dramatically since March 31, 2010. Mr. Paroian commented that four events seemed to have reintroduced uncertainty and doubt in the markets. The debt situation, not only in Greece but in almost all developed countries, is a huge worry. On May 6, there was a market malfunction that caused the market to crash but then almost immediately bounce back, and no one is certain of the cause. The prospect of financial regulation creates uncertainty. And finally, China, which has been an engine of world growth, has been tightening and slowing down.

Volatility, as measure by the VIX index, has risen to levels not seen in the past year. Mr. Paroian commented that this type of volatility is worrisome and likely to stay for the near and immediate term. He commented that, especially in this environment, performance of markets and managers quarter-to-quarter may not mean a lot; concentrating on the long-term is important.

Looking at market performance for the year-to-date, including the positive first quarter and the more recent volatility, the U.S. equity market is now down about 3 percent, the World index is down about 8 percent, and emerging markets are down about 9 percent year-to-date. Since last year, emerging markets are still up about 90 percent and developed markets had about a 70 percent run up so, in some respects, a 5-10 percent pull-back is not surprising. The key will be whether things stabilize or continue to fall.

Mr. Paroian commented on the portfolio's position, noting the WSIB funded its new emerging markets managers over the quarter end. The portfolio has closed its previous emerging market underweight and is now neutral weighted, which may or may not be a good in the short term but is a long-term strategic decision for the WSIB. He said the largest sector underweighting is in financials, and there was an overweighting in telecommunications.

Mr. Paroian said the portfolio performed about in line with the index. Four out of five of the emerging markets managers outperformed for the quarter, and five out of nine within non-U.S. outperformed. This is consistent with WSIB's strategy to focus on active management in emerging markets and non-U.S./global mandates going forward.

For the L&I and Permanent Funds, all equity is passive and performed in-line with the benchmarks.

In the defined contribution programs – Plan 3s and the DCP – there are balanced options available for those who desire a one-step investment. The target date funds are outperforming their custom benchmarks. The Total Allocation Portfolio and the Socially Responsible funds are outperforming long term. The equity options in Plan 3 are passive and have performed in line with the indexes. The equity options in DCP are a mix of passive and active and have had mixed results long-term. He noted investment options within Plans 3 and DCP are currently under review with the Department of Retirement Systems.

Real Estate
Mr. Draper commented that, broadly speaking, many of the real estate markets are still fundamentally weak, particularly for the U.S. and Europe and within retail and office space. There are some bright spots within emerging markets. He said that because fundamentals are not good, some transactions occurring do not seem to make sense, with aggressive pricing in certain markets such as Washington D.C. and London. Opportunities are more challenging to find.

Mr. Draper noted the real estate performance data contained within the Board packet, which reflects write-downs in the portfolio. He said that some of the larger write downs were to long-term partners that staff believes are some of its best partnerships and there is little long-term performance concern. He reported the portfolio has benefitted from its healthcare investments. Mr. Draper believes some WSIB partnerships have overcompensated in their write-downs in order to be conservative and thinks values will start to come up before actual recovery occurs within the real estate markets. The WSIB still has meaningful outperformance compared to many of its peers.

Private Equity
Mr. Ruggels reported on changes within the private equity portfolio over the past year. The one-year return for 2009 was about 20 percent, which approximately offsets the loss experienced in the fourth quarter of 2008. The portfolio's valuation is back up to about $13.5 billion, or 24.6 percent of the CTF—very close to the 25 percent target allocation. This rebound in valuation is tied to the rebound in the public equity markets during the past several months. The credit markets have also recovered significantly, and investment activity is picking up. Mr. Ruggels reported that, year-to-date in 2010, drawdown and distribution activity in the portfolio is tracking well ahead of the comparable period in 2009. He expects this trend to continue throughout the year, barring some unforeseen event. He reported the private equity markets appear to be returning to more normal activity levels, after a very slow period in the first half of 2009.

[Mr. Seely left at 12:41 p.m.]

Private Equity
Mr. Woolford reported on private equity market conditions during the first quarter. He discussed exits, pricing, investment pace, and fundraising. He also discussed performance comparisons and correlations between middle-market and large/mega cap buyout funds. He said IPO activity is still relatively modest, but that sales to other financial sponsors and strategic buyers have picked up. Fundraising continues to be difficult. He noted some investors are abandoning large cap private equity, but he believes the WSIB has done a good job with manager selection and, due to program size and resources, large cap will continue to be an important component of the WSIB program.

OTHER ITEMS
There was no further business to come before the Board and the meeting adjourned at 12:53 p.m.

Patrick McElligott
Chair

ATTEST

Theresa J. Whitmarsh
Executive Director