

**WASHINGTON STATE INVESTMENT BOARD**

**Board Meeting Minutes**

**November 18, 2010**

The Washington State Investment Board met in open session at 9:57 a.m. in the boardroom at 2100 Evergreen Park Drive SW, Olympia, Washington.

Present: Pat McElligott, Chair (via teleconference)  
Treasurer Jim McIntire, Vice Chair  
Senator Lisa Brown  
Steve Hill  
William Longbrake  
George Masten  
Richard Muhlebach  
Bob Nakahara  
David Nierenberg  
Judi Owens  
Mike Ragan  
Representative Sharon Tomiko Santos (via teleconference)  
Jeff Seely

Absent: Judy Schurke

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  
Tom Ruggels, Senior Investment Officer – Private Equity  
Diana Will, Senior Investment Officer – Asset Allocation  
Maria Tosteson Rosen, Assistant Senior Investment Officer –  
Fixed Income  
Allyson Tucker, Assistant Senior Investment Officer – Public  
Equity  
Kristi Haines, Executive Assistant  
  
Steve Dietrich, Attorney General's Office  
David Woolford, Capital Dynamics

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

Acting Chair McIntire called the meeting to order and took roll call.

## **ADOPTION OF THE SEPTEMBER 16, 2010, MINUTES**

**Mr. Ragan moved to adopt the September 16, 2010, Board meeting minutes.  
Mr. Masten seconded, and the motion carried unanimously.**

### **PUBLIC COMMENT**

Ms. Whitmarsh said a constituent had written the WSIB requesting information on holdings within the Deferred Compensation Program. Historically holdings have not been published but staff worked with the constituent and now has its top ten holdings lagged one quarter posted on the Web site. The constituent is satisfied with this response and asked for his letter to be put into the record. Mr. Bruebaker said staff has planned a project for next year for more disclosure.

### **PUBLIC MARKETS COMMITTEE REPORT – DEFINED CONTRIBUTION OPTION CHANGE IMPLEMENTATION PLAN**

Mr. Ragan reported the Public Markets Committee met on November 2 to consider the implementation plan for the revised defined contribution investment options, which were approved by the Board in September.

**Mr. Ragan moved that the Board approve the proposed implementation approach to the new defined contribution options. Ms. Owens seconded the motion.**

Mr. Ragan said, while most of the investment options offered to participants did not change, the equity options were simplified and harmonized among the plans so that each offers the same basic building blocks, which will serve members well. The equity options are U.S. equity large cap, U.S. equity small cap value, global equity, and emerging markets equity. Staff recommends passive management for U.S. equity, a mix of passive and active management for global equity, and primarily active management for emerging markets equity.

He said advantages to the proposed implementation plan is that it is consistent with the WSIB's investment beliefs; keeps changes to a minimum; can be implemented without any additional searches beyond the current global equity selection process; focuses WSIB staff with the investment management firms the Board knows best and has the highest conviction in; adds manager diversification to equity options that include active management; and incorporates industry best practices in terms of multi-manager implementation.

There are some operational challenges associated with the recommended strategy and public equity staff will continue working with operations staff to explore the feasibility and logistics of implementing multi-manager options and surveying our existing managers about their ability to offer daily liquidity defined contribution vehicles. Staff will report to the Public Markets Committee on the outcome of this research. If it turns out that multi-manager options are infeasible logistically, staff will re-examine the recommended implementation.

Also, following the completion of the global equity search, public equity staff will model which combinations and weights of global and emerging markets managers are appropriate for the defined contribution programs and report those results and recommendations to the Public Markets Committee.

WSIB staff will continue to coordinate closely with the Department of Retirement Systems throughout this process.

**The above motion carried unanimously.**

## **PRIVATE MARKETS COMMITTEE REPORT**

Mr. Masten reported the Private Markets Committee met on November 4, 2010, to consider five investment recommendations.

### **Vestar Capital Partners VI, L.P.**

**Mr. Masten moved that the Board invest up to \$200 million plus fees and expenses in Vestar Capital Partners VI, L.P., subject to continuing due diligence and final negotiation of terms and conditions. Ms. Owens seconded the motion.**

Mr. Masten said the fund has a target size of \$3.7 billion and will invest in management buyout, growth equity, and recapitalizations in the United States and Europe. The WSIB has invested in three prior Vestar funds. He said the recommendation is based, in part, on Vestar's experienced and cohesive investment team; long-term, consistent track record; and fits nicely in the WSIB's private equity portfolio.

**The above motion carried unanimously.**

### **KSL Capital Partners III, L.P.**

**Mr. Masten moved that the Board invest up to \$200 million plus fees and expenses in KSL Capital Partners III, L.P, subject to continuing due diligence and final negotiation of terms and conditions.**

Mr. Masten reported the fund has a target size of \$1.5 billion and will pursue acquisitions of under-managed or under-capitalized travel and leisure businesses. The WSIB has invested in two prior KSL funds. He said the recommendation is based, in part, on KSL's experienced management team; strong performance with substantial realizations; focused, niche strategy; favorable market environment for this strategy; and excellent fit in the WSIB's private equity portfolio.

Representative Santos said she voted against the proposal at the Committee meeting, expressing concerns that she has not had the opportunity to have alleviated, and she plans to vote against the investment recommendation today. Acting Chair McIntire said he supports the recommendation, but had also expressed concerns at the Committee meeting. He said information forwarded since the meeting by Mr. Bruebaker had set his concerns aside, and he believes it is an appropriate strategy.

**Mr. Ragan seconded the motion. The above motion carried, with Representative Santos voting no.**

### **Evergreen Real Estate Partners, LLC**

**Mr. Masten moved that the Board invest an additional \$500 million, plus fees and expenses, in Evergreen Real Estate Partners, LLC, subject to continuing due diligence and final negotiation of terms and conditions. Mr. Ragan seconded the motion.**

Mr. Masten said the partnership will invest in or with real estate operating companies on a global basis, consistent with the WSIB's primary strategy for real estate investment. The WSIB has previously committed \$2 billion to Evergreen in \$500 million increments since 2004. He said the recommendation is based primarily on Evergreen's strategy, its high-quality management

team, and the governance rights the WSIB maintains through our exclusive relationship with them. Evergreen has exhibited good underwriting skills and has shown restraint and patience in their investment process. The partnership also provides the WSIB with additional diversification benefits, both geographically and by property type. This follow-on investment appears to be an excellent fit in the WSIB's real estate portfolio. The proposed investment is consistent with the updated annual plan for real estate discussed at the July Board meeting.

**The above motion carried unanimously.**

#### **Lone Star Fund VII (U.S), L.P.**

**Mr. Masten moved that the Board invest \$300 million, plus fees and expenses, in Lone Star Fund VII (U.S.), L.P., and that the investment be placed in the Innovation Portfolio, subject to continuing due diligence and final negotiation of terms and conditions. Further, that the investment not be subject to the 1 percent allocation limit within the Innovation Portfolio Policy 2.10.800 since this is being approved by the Private Markets Committee and the Board.**

**Mr. Ragan seconded the motion.**

Mr. Masten reported the WSIB has invested over \$2 billion in six Lone Star funds since 1996. However, over the past several funds, Lone Star has shifted its strategy to focus less on real estate or debt directly collateralized with commercial real estate to investments in distressed whole-loans, debt, securities and structured products, financial institutions, and corporate and consumer credit. While some of these opportunities are collateralized by residential real estate, the actual ownership is through securities or debt instruments. The value that Lone Star aims to create is done through the understanding of complicated debt structures, being able to collapse and navigate those structures, as well as navigate cash flow waterfalls. Therefore, the strategy is not necessarily real estate or private equity, nor is it specifically fixed income. He said the recommendation is based largely on Lone Star's very strong long-term track record and their proven management team. In addition, they offer a vertically-integrated organization with internal loan servicing capacity. It should be noted that the fund's terms are favorable at this level of investment.

**The above motion carried unanimously.**

#### **Sheridan Production Partners II, L.P.**

**Mr. Masten moved that the Board invest \$125 million, plus fees and expenses, in Sheridan Production Partners II, L.P., subject to continuing due diligence and final negotiation of terms and conditions.**

Mr. Masten said the fund has a bigger target size of \$1.75 billion and will invest in mature, producing oil and gas properties within the continental United States and state or shallow waters in the Gulf of Mexico region. Sheridan will not invest or participate in any projects in federal or deep waters. He said the recommendation is based, in part, on Sheridan's strong management team and their significant experience in the fund's targeted regions; relatively lower-risk, cash generating approach to the oil and gas sector; and their strong performance to date. The proposed investment is recommended at \$125 million in light of the performance of Sheridan I and the larger fund size of Sheridan II. The updated annual plan for tangible assets discussed at the July Board meeting had Sheridan II penciled in for \$75 million.

**Mr. Ragan seconded, and the motion carried unanimously.**

## **ADMINISTRATIVE COMMITTEE REPORT**

### **Investment Officer Compensation Plan Discussion**

Mr. Moore introduced the updated Investment Officer compensation plan, which was tabled for discussion in April by the Administrative Committee. Staff addressed some of the concerns raised by the Committee and the Joint Legislative Audit Review Committee, which adjusted the salary levels and narrowed the range. Staff also did some surveying of positions in the back and middle office to pension funds of similar size to the WSIB. Mr. Moore noted there is currently a state salary freeze in effect. The proposed ranges, if adopted, would require both legislative authority and funding.

Mr. Moore described the top of the 40 percent ranges are set at the median level of surveyed funds. He said median levels were used in the survey rather than the average as peer organizations' average salaries also include bonus pay, and the two numbers are not that different. The peer organizations manage between \$30 to \$80 billion in assets, and some of the larger funds (New York, California, and Florida) were removed from the survey as it was felt they were not comparable to the WSIB.

In response to Representative Santos' questions, Mr. Moore reported that 11 funds with comparable assets under management were included in the survey and he was unsure if the number of pensioners was also comparable. The WSIB statute deals with the size of the fund. Staff also proposes salary bands for positions in the back and middle office, with a 40 percent salary spread and 15 percent differentiation between the three band levels to reflect responsibilities of the various positions within those levels. He reported the Administrative Committee recommended moving the matter to the full Board. If the Board were to adopt the proposal, the agency is still prohibited from granting increases and is not obligated to pay anything retroactively. The Board would simply acknowledge and adopt the salary structure.

Representative Santos expressed concerns with the timing of the salary proposal and pressure for appropriations. Treasurer McIntire suggested the Board may want to defer action on the item to a future meeting. Senator Brown concurred. She agreed with the methodology of the study and rationale for adopting is well reasoned, but the timing is not ideal and may be misunderstood by the public. Mr. Ragan said he was torn, and there is never a good time to ask for money. He would vote to set up the framework for a future appropriation, but would not object to deferring action. Mr. McElligott said he preferred to defer to the next Board meeting. Ms. Owens said she is interested in having the best investment team in place and supports having the salary enhancements in place even though she understands that the state has a freeze. She is comfortable moving ahead because she knows it will not be implemented until the freeze has been lifted.. Mr. Masten said there are times when it is appropriate to hunker down and protect what you have. Staff understand that this is one of those times. He believes it would be a serious mistake to pass this when state employee are getting hit hard by layoffs, salary freeze, and furloughs. Mr. Seely said he supports the proposal although it cannot be enacted. It is important to keep staff and fill vacancies.

**The above motion was tabled for future discussion.**

[Mr. Masten departed at 10:35 a.m.]

### **Succession Planning**

Acting Chair McIntire reported that Ms. Whitmarsh has provided the Administrative Committee an update on management team's approach to succession planning. She discussed how the WSIB is better positioned today than at any time in the past to ensure successful transitions. She described the career tracks that have been developed in investments through broader use of the Assistant

Senior Investment Officer job classification and how management is working with Investment Officers and Assistant Senior Investments Officers to develop them through additional duties and educational opportunities. She noted that the executive management team and Senior Investment Officers have strong commitment to the WSIB and no departures within the near term are expected. However, there is a contingency plan in place in case of a sudden or unexpected departure. Ms. Whitmarsh said she would discuss succession planning annually with the Administrative Committee since it is fluid and not possible to set in stone.

### **EXECUTIVE DIRECTOR'S REPORT**

Ms. Whitmarsh reported that members would be polled for conducting the upcoming Private Markets Committee on December 3 as two members reported conflicts with December 2. She said that Mr. Dietrich had updated the Administrative Committee earlier today on the State Street settlement. The WSIB receive<sup>3</sup> a great deal of press interest on the matter. She thanked both Treasurer McIntire and Mr. Dietrich for their great work. Ms. Whitmarsh reported a job offer is planned for the Human Resource Director position. Management had a finalist for the Senior Investment Officer – Tangible Assets position, but the candidate declined the offer due to a combination of salary level and location. Finally, Ms. Whitmarsh updated members on the status of open procurements and quiet periods in place.

[The Board took a brief recess at 10:41 a.m., and reconvened in open session at 10:55 a.m.]  
[Representative Santos and Mr. McElligott were no longer in attendance via teleconference at 10:55 a.m.]

### **CONFLICT OF INTEREST/ETHICS EDUCATION SESSION**

Mr. Dietrich conducted the annual training session on the Board's Conflict of Interest policy and Washington State ethics law relating to gifts, meals and travel, confidential information, insider trading, personal investment, employment after state service, use of state resources and special privileges, disclosure and filing requirements, recusal, and sanctions for violations.

Mr. Seely suggested a review and update of the Conflict of Interest Policy to address exchange-traded funds. Ms. Whitmarsh said these trades are currently handled by side letter but it makes sense to update the policy.

Mr. Dietrich also addressed the Securities and Exchange Commission's new rule on campaign contributions ("pay-to-play"). Treasurer McIntire urged the Attorney General's Office to make sure notification is made to affected officials prior to the March 14, 2011, effective date.

### **COST EFFECTIVENESS MEASUREMENT FOLLOW-UP**

Mr. Moore relayed there were questions relating to the cost trend data presented by Cost Effectiveness Measurement at the September Board meeting. The results of the survey showed a significant increase in annual operating cost during 2007-2008, which was due to a methodology change of CEM in accounting for private equity rebate fees. Staff requested an apple-to-apples comparison to eliminate the methodology change. The results showed only a slight increase in operating costs for the calendar year. Mr. Bruebaker reminded members the Board increased private equity in 2008, which resulted in increased costs. Mr. Moore reported the WSIB's excess costs savings over peers improved to 16.1 basis points. The survey includes data from appropriately 1,200 funds within CEM's database.

Acting Chair McIntire announced agenda item 11, Non-voting Board Members Evaluation, is deferred to a future meeting.

## QUARTERLY DISCUSSION OF MARKETS

### Portfolio Discussion

Mr. Bruebaker reported this was a good quarter for investment returns and continues to be a good year. The Commingled Trust Fund (CTF) was up 7.7 percent for the quarter ended September 30, 2010, and up 10.91 percent for year then ended. The U.S. Equity market is up 3.6 percent since September 30, 2010. The since inception return for the CTF is up 8.48 percent as of September 30, 2010, and up 8.55 percent as of October 31, 2010.

Relative to implementation value added, Mr. Bruebaker said the WSIB is now outperforming for the quarter, the 1, and 10 year periods; while underperforming for the 3 and 5 year periods. This quarter, allocation decisions hurt investment performance by 17 basis points. Specifically, being underweight global equities hurt by 22 bps, being overweight private equity hurt by 10 basis points; while the overlay program assisted by 13 basis points and the Innovation portfolio helped by 9 basis points. Manager decisions worked out very well. While the portfolio was hurt a little by real estate manager performance by 33 basis points; the fixed income team assisted investment performance by 35 basis points and private equity managers assisted by 426 basis points. The portfolio continues to be well positioned for the long term.

### Fixed Income

Ms. Tosteson Rosen reported that for the quarter ended September 30, the retirement portfolio returned 4.45 percent versus 2.89 percent for the Barclays Universal Index, an outperformance of 156 basis points. The major sector returns for the index were Governments returning 2.52 percent, Credit 5.10 percent, and Securitized 1.11 percent. The credit overweight was responsible for most of the outperformance. She said government securities underperformed and interest rates fell. Securitized outperformed. For the calendar year-to-date through November 17, the retirement fund returned 8.78 percent outperforming the index by 77 basis points, and for the fiscal year-to-date it returned 4.23 percent, an outperformance of 160 bps. For the Labor and Industries' funds, the accident fund returned 4.71 percent, medical aid returned 4.92 percent, and pension reserve returned 4.67 percent for the quarter. The Bond Fund returned 4.22 percent for the quarter. Mr. Bruebaker thanked Ms. Tosteson Rosen for her good work, commenting the WSIB did not lose a single dollar on mortgage investments due to her work.

Ms. Tosteson Rosen updated the Board on Fixed Income's economic outlook and current market conditions. They believe the economy will grow at 1.5 to 2 percent for the next two years, unemployment will remain high, housing will continue to be weak, and consumers will continue to delever. She commented on three key issues affecting the fixed income markets, which are quantitative easing, currency wars, and the European sovereign debt crisis.

[Senator Brown left the meeting at 11:42 a.m.]

### Public Equity

Ms. Tucker reported public equity had a strong third quarter; the Dow Jones Global index ended September up 14.6 percent. The major event during the quarter was the Fed's signaling to markets at the end of August and the subsequent pricing in of its desire to launch a second round of Quantitative Easing. Equity markets responded to reflect the view that a double-dip recession was less likely, a concern that dragged markets down earlier in the year. Another event in the third quarter was currency movement. Most currencies appreciated versus the U.S. dollar, leading to strong global returns for U.S.-based investors. The U.S. equity market experienced its strongest September since 1939 and its strongest quarter in nearly two decades. Ms. Tucker reported all global sectors posted gains, with more cyclical sectors outperforming defensive sectors, especially in emerging markets. Generally, growth outperformed value.

Within the CTF, the global equity portfolio modestly underperformed its benchmark. Ms. Tucker discussed sector and manager performance. Three of the seven active managers outperformed within the International active portfolio, and within Emerging Markets four of the seven accounts outperformed. For the Labor and Industries' and Permanent funds, all equity is passive and performed in line with indices. The Plan 3s and Deferred Compensation Program (DCP) target date funds are on track and outperformed for the quarter. The Social Responsible Fund modestly underperformed its benchmark for the quarter, but continues its outperformance over all longer-term time periods. Within Plan 3, all equity options are passive and three of the four equity strategies outperformed their benchmarks in the third quarter, and all four are ahead of their benchmarks over the 1-year period. With the DCP, five out of six of the equity strategies outperformed their respective benchmarks for the quarter, and four out of six outperformed on a one-year basis. Ms. Tucker reported that no rebalancing or portfolio shift activities took place in during the third quarter; however, staff did transition the commingled international passive account to a separate account.

### Real Estate

Mr. Draper said the real estate portfolio continues to stabilize although valuations have been and are likely to remain flat to slightly higher. The portfolio is producing strong income, with a return over the past year of 7.3 percent. Hometown, Terramar, CPA, and Union Square returned income of 6.2, 7.0, 7.7, and 9.0 percent respectively over the past year. He said income returns are an attractive component of real estate. The healthcare sector has been an exceptional performer, and the portfolio's overweighting has done well, as this sector not only did not decline with the downturn, it produces a large amount of income. Of the portfolio's 10-year net return of 8.5 percent, 6.4 percent was income.

Mr. Draper said pension and sovereign funds are pouring into real estate with most of that money going into high-quality "core" properties in gateway cities, primarily in property types such as office buildings. Investors have begun to seek better governance and control in investments. He said that lending is picking up as terms have loosened up a lot both in terms of amount available to loan on aggregate basis and higher loan to value ratios being accepted. Foreign investor money is coming into the U.S. and other countries, but there is weak investor demand in some parts of Europe. The multi-family property sector is also picking up strongly in some U.S. markets.

Mr. Draper responded to Board members questions about lightening up on the healthcare overweighting; the demand for multi-family dwellings, specifically in Washington D.C. and California; and historical investment trends of other countries that may repeat themselves in the current cycle.

### Private Equity

Mr. Ruggels reported that, for the second quarter, the private equity portfolio had a slightly negative return of 0.4 percent, but the one-year return was 21.1 percent. The program is beating its benchmark for the 1-, 3-, 5-, and 10-year periods. Over the last few quarters drawdowns and distributions have continued to increase. In each of the last three months, distributions have exceeded drawdowns, as many funds are focusing on exits to position themselves for their next fundraise. Staff is anticipating a significant increase in fundraising activity in 2011, and is expecting to bring forward 12 or more deals for approval next year, or about twice the number of deals done per year in 2009 and 2010. The credit markets continue to show surprising strength, allowing many companies to reposition their capital structures, extend maturities, and in some cases pay dividends to the private equity sponsors.

Mr. Ruggels reminded the Board that the contract with private equity consultant Capital Dynamics expires as of December 31. He said that the private equity team had enjoyed working with

Mr. Woolford and his team over the past five years, and thanked Mr. Woolford for the significant work done by Capital Dynamics on behalf of the program. Acting Chair McIntire also shared his thanks on behalf of the Board. Mr. Woolford agreed that the partnership between our organizations has moved the WSIB program along very well, and he congratulated the Board on hiring Hamilton Lane as its future consultant.

Mr. Woolford presented Capital Dynamics' views on the current economic environment and implications for private equity in 2011. He discussed recent trends in investment activity, liquidity events, and fundraising. He said fundraising may continue to be difficult in 2011, with emerging markets as an exception. Mr. Woolford said many managers may find it difficult to get funds fully invested prior to the expiration of their commitment periods over the next 2-3 years.

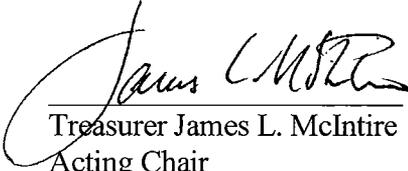
[Mr. Hill was in attendance at 12:27 p.m.]

[The Board briefly recessed at 12:38 p.m., and reconvened in open session at 12:43 p.m.]

#### **OTHER ITEMS**

Acting Chair McIntire raised his observation that it appeared investment staff in the various asset classes had differing views on the economic outlook. Members and staff engaged in a discussion of how diverse opinions in the various asset classes, sectors, geographies, etc., can be healthy for the portfolio just as investments will perform differently during different time periods.

There was no further business to come before the Board and the meeting adjourned at 1:08 p.m.

  
Treasurer James L. McIntire  
Acting Chair

ATTEST

  
Theresa J. Whitmarsh  
Executive Director