

**WASHINGTON STATE INVESTMENT BOARD**  
**Board Meeting Minutes**  
**April 21, 2011**

The Washington State Investment Board met in open session at 9:35 a.m. in the boardroom at 2100 Evergreen Park Drive SW, Olympia, Washington.

Present: Pat McElligott, Chair  
Treasurer Jim McIntire, Vice Chair  
Steve Hill  
William Longbrake  
George Masten  
Richard Muhlebach  
Bob Nakahara  
Judi Owens (via teleconference)  
Natasha Pranger  
Mike Ragan  
Judy Schurke  
Jeff Seely

Absent: Senator Lisa Brown  
David Nierenberg  
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 Estate  
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  
Chris Green, Risk Analyst  
Kristi Haines, Executive Assistant

Steve Dietrich, Attorney General's Office  
Andrew Turner, Northern Lights Capital Group

[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**

Chair McElligott administered the oath of office to Natasha Pranger, newly appointed Board member, who fills the unexpired term of the Active PERS member effective April 12, 2011, until December 31, 2011.

## **ADOPTION OF THE FEBRUARY 17, 2011, MINUTES**

**Mr. Masten moved to adopt the February 17, 2011, Board meeting minutes.**

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

## **PUBLIC COMMENT**

There was no public comment.

## **EXECUTIVE DIRECTOR'S REPORT**

On behalf of Ms. Whitmarsh, Ms. Haines reported the agency had contracted with BoardDocs, a web-based system recommended by Ms. Owens, to automate the creation and distribution of Board and Committee meeting packets. Staff underwent training on the BoardDocs system, and Board members will be introduced to automated processes in May.

Ms. Sandboe highlighted staff's activities over the past year in identifying and communicating with companies within the WSIB portfolio that conduct business within Iran and Sudan, to encourage them to cease operations within those countries. Staff also maintains ongoing communications with activist organizations.

Ms. Sandboe announced that Patrick McElligott was elected to the Council of Institutional Investors Board of Directors at its spring meeting. Chair McElligott thanked staff for their assistance with the nomination process.

## **CAPITAL MARKETS ASSUMPTIONS**

### **Introduction**

Mr. Lerch introduced the planned presentations for the Board's information and consideration of staff's 2011 capital markets assumptions recommendation. He described that capital market assumptions are projected characteristics and behaviors of each asset class over the long-term, 15+ years. Capital market assumptions are updated annually based on financial market theory, staff views, and input from consultants. He said capital market assumptions are used by staff during asset allocation studies, the State Actuary in developing contribution rate calculations considered in the state budgeting process, and the Guaranteed Education Tuition Program in setting tuition unit prices.

Mr. Lerch said there may be increased interest in capital market assumptions this year due to the current economic situation, impacts of recent events in Japan and the Middle East, attention to pension contribution rates, and the pension funding impact on the state's budget. Mr. Longbrake asked if and how staff factors such considerations into its work. Ms. Will said she considered Mr. Rob Arnott's February Board presentation, economic models, consultants' thinking, and theories about what markets should do and what staff believes will actually happen in building the proposed capital market assumption numbers. Mr. Bruebaker said the Board should consider what it believes and can support in making its capital market assumptions decision.

Mr. Lerch summarized Mr. Arnott's views on the impacts of rising debt and aging populations in developed countries, and an expectation of lower returns going forward. Mr. Arnott believes achieving a 7 to 8 percent return over the next 10 years will require typical portfolio mixes to achieve top quartile results in all asset classes, or using non-traditional or tactical asset allocation strategies. Mr. Lerch noted there is wide dispersion of views on expected returns.

### **Expected Equity Risk Premium – Issues and Anomalies**

Mr. Andrew Turner, Northern Lights Capital Group, presented information, methods, and challenges of estimating long-term returns for pension funding purposes based on historical trends, relationships between fundamental factors, and macroeconomic analysis of trends, country characteristics, and time periods. He demonstrated how historical data and different perspectives in framing problems or situations provide perspective on what is happening currently and what may happen in the future. Mr. Turner described the circumstances, consequences, relationships, and differences of historical recessions and financial crises on returns. He shared perspectives relative to current economic circumstances and considerations for equity risk premium expectations. He emphasized that globalization has connected emerging markets to the U.S.

Mr. Turner illustrated changes in interest rates, short- and long-term bonds, and price-to-earnings ratios over historical time periods, detailing differences of why similar returns should not be expected going forward. He described how inflation is not good for stocks in the short-run, and how globalization and increases in trade are likely to act as a brake on emerging markets equity returns.

Mr. Turner said that pension funds with heavy weightings in equities are likely to experience disappointing returns and funds should avoid chasing the same return courses. He suggested that returns should be sought in less usual spaces and strategies. Mr. Longbrake said this is true for different asset classes, consultants, returns, and managers. A discussion ensued relating to the WSIB's good performance in private equity based on its allocation and early entrance into that sector. Mr. Longbrake commented the WSIB should not only look at its own situation, but also what other thought leaders are doing and where they are dragging others. Sometimes it is the right place to be for awhile, but exit at the right time.

### **Are WSIB Investment Return Assumptions Achievable?**

Mr. Bruebaker presented information on Washington's actuarial rate of return assumption and whether or not it causes intergenerational inequities. He reviewed the pension funding model, the 2010 WSIB capital market assumptions, and displayed Commingled Trust Fund (CTF) returns since inception, versus implementation value added, 12-month net of fees, and as compared against the growth of the dollar. He discussed the basic fundamentals of retirement investment in terms of contributions accumulation and drawdown, and projected contribution levels using 5.5, 7.5, and 8.0 percent return assumptions.

Mr. Bruebaker described impacts within the investment world that can be controlled or significantly influenced by the WSIB and the state, and those impacts that cannot be controlled or influenced such as financial markets, federal issues, and member life span changes. He suggested that actuarial rates relative to contribution rate setting should approximate expected investment returns. He demonstrated how different rates of return can create different outcomes that impact either current or future generations. He believes the average public pension fund probably will not be able to earn an 8 percent return, and he is unsure if the WSIB can do so despite its 8.7 percent since inception return. He said he does not believe the next 20-year returns will look like the past 20 years, but the

WSIB will do its absolute best as directed by the Legislature to maximize investment returns at a prudent level of risk. Mr. Bruebaker said the WSIB is positioned better than the average pension fund, but it may be challenging to sustain returns going forward.

The Board discussed the importance of defined benefit plans, the trend in pension funds shifting to defined contribution plans, reasons why the private sector has shifted to defined contribution plans, and related risks, impacts to taxpayers and pensioners, political aspects, and lack of general understanding of the issues.

Mr. Hill shared concerns with the Board's decision on expected returns over the next 15-years. He pointed out that high assumptions can drive benefit improvements. An 8 percent return is uncertain going forward in the general market, as is the assumption that the current skill and competency levels at WSIB today can be maintained for 20 to 30 years. He questioned whether that message has been clearly communicated with policymakers. Treasurer McIntire said the WSIB should examine pricing risk and lower return measurements differently, including the risk involved and long-term investment strategy in going to a defined contribution plan. Mr. Bruebaker said staff would implement whatever is directed by the Board and Legislature, but any transition would not be without cost. A move to defined contribution would require a much lower allocation to illiquid asset classes and would result in a lower return. Mr. Masten said the WSIB is charged with investing money at a prudent level of risk and funding of pension plans is a political issue that should be left to employee and retiree organizations.

[The Board recessed at 11:43 a.m., and reconvened in open session at 12:02 p.m.]

### **2011 Capital Market Assumptions Staff Recommendation**

Ms. Will said capital market assumptions quantify the expected average annual return and risk level of each asset class over the long-run and the correlation between each asset classes. She described the return numbers used in the modeling process are arithmetic, rather than geometric returns. The returns assumptions are based on historical information and adjusted for anticipated fundamental changes to long-term returns. Standard deviations are projected rates around the returns. Ms. Will said that multiple correlations between asset classes are examined in the modeling process. The assumptions are set looking at a 15-year time period but takes into consideration changes that can happen in the short-term. Ms. Will described that she begins building capital market assumptions with WSIB consultants' return and risk projections and inputs the best ideas into the recommendation. Compared to last year, almost all asset classes have a little lower returns and slight changes in standard deviations, but very little correlation changes.

Ms. Will said the WSIB capital market assumptions are used by the State Actuary for modeling, the Guaranteed Education Tuition Board in setting college tuition unit pricing, and will be used by the Permanent Funds in examining whether to add an equity component to its allocation.

Mr. Hill shared his concern that the fixed income number seems high given the current bond market, as well as the risk premium. Ms. Will described the maturation of the fixed income portfolio over the 15-year time frame and its effect on the yield curve. Mr. Longbrake spoke in support of the proposed fixed income return, and suggested it could be even higher. He complimented the thoroughness of white paper contained within the Board materials.

**Mr. Masten moved the Board adopt the 2011 WSIB capital market return, risk, and correlation assumptions as stated in the following table. Treasurer McIntire seconded the motion.**

	Arithmetic Return	Standard Deviation								
TIPS	4.00	6.00								
Fixed Income	4.25	5.00								
Tangible Assets	6.50	8.00								
Real Estate	8.00	15.00								
Global Equity	8.65	17.62								
U.S. Equity	8.50	17.00								
International Equity	8.75	19.50								
Private Equity	11.50	27.00								
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	0.15	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	0.10	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	

In response to questions from Mr. Longbrake, Ms. Will said the approved capital market assumptions would be used in any future asset allocation studies. The CTF asset allocation study is typically conducted every four years, with the last study completed in 2009. The assumptions would not impact the CTF at all this year. Ms. Will said she does look at ongoing CTF effects and reasonableness within other portfolios, and would alert the Board if she anticipates any issues. Ms. Whitmarsh said the assumptions are revisited every year and the State Actuary accepts the assumptions but does an independent study and adjusts for a 50-year time basis in preparing his report that the Legislature considers in its budget building process.

**The above motion carried unanimously.**

## **PUBLIC MARKETS COMMITTEE REPORT**

### **Active Global/Non-U.S. Equity Markets Investment Management Recommendation**

Mr. Ragan reported the Public Markets Committee met on March 1 and 2 to interview finalists for the active global/non-U.S. equity markets investment management search.

Staff conducted a comprehensive review of the public equity structure in the CTF as part of the 2010 Public Equity Annual Plan. As a result of the review, the Public Markets Committee and Board approved moving the public equity CTF program toward more global strategies from

traditional domestic and international specific mandates. This focus is consistent with the Board's 6-year strategic plan and the Board's investment beliefs.

Staff conducted a thorough pre-procurement background research process prior to release of the formal search document. The first screen after the formal search process began narrowed the search to 33 strategies with 31 different firms. From that list, 19 firms were chosen to proceed to semi-finalist video conferences and the candidates were then further narrowed to 13 firms. Staff met with those 13 firms in Olympia and then selected 9 to visit onsite at their respective offices.

Staff recommended nine firms to the Public Markets Committee. For the primary roster of active managers, four incumbents and two new managers were recommended. Staff also recommended three satellite managers that provided interesting long-term return opportunities. During the ongoing due diligence process, preliminary contract negotiations with one of the satellite managers were unsuccessful and that candidate subsequently withdrew from consideration.

The Public Markets Committee heard presentations from the remaining eight firms. The Committee unanimously recommends the Board hire seven managers.

**Mr. Ragan moved that the Board hire the following managers for the global/non-U.S. active equity mandate within the CTF, subject to continued due diligence and successful negotiation of terms and conditions:**

- **Aberdeen Asset Management PLC**
- **Arrowstreet Capital, L.P.**
- **Mondrian Investment Partners Limited**
- **William Blair & Company, LLC**
- **Longview Partners LP**
- **Tradewinds Global Investors, LLC**
- **Wentworth, Hauser and Violich**

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

Mr. Ragan reported the Committee also recommends hiring DE Shaw Investment Management.

**Mr. Ragan moved that the Board hire DE Shaw Investment Management, LLC for the global/non-U.S. active equity mandate within the CTF, subject to continued due diligence and successful negotiation of terms and conditions. Treasurer McIntire seconded the motion.**

Mr. Masten stated a concern the manager is a quantitative manager, and he recalled past quantitative managers that did not perform well. He said this manager said their annual turnover tends to be very high, at 250 percent per annum. He does not believe they are long-term investors. He shared the manager relies on automated buy/sell decisions, which he opposes and he will vote no on this recommendation.

**The above motion carried, with Mr. Masten voting no.**

## **AUDIT COMMITTEE REPORT**

Mr. Hill reported the Audit Committee met on March 1. The Committee received an internal audit report of the Fixed Income investment program. The audit was very clean, with one audit recommendation agreed to by management. The Audit Recommendations Status Report was also presented, with 5 of the 8 recommendations resolved during the quarter. Monitoring of the remaining recommendations will continue and reported on at the next Committee meeting. Staff presented the Annual Investment Compliance Report: Public Equity, Fixed Income, Cash Overlay, and Securities Lending funds were found to be 100 percent in compliance, and the Asset Allocation fund was 99.86 percent in compliance. Staff also presented compliance results for Private Equity, with 130 funds tested and found in compliance; and in Real Estate and Tangible Assets, with 14 investment vehicles tested and found in compliance.

[Mr. Ragan left the meeting at 12:37 p.m.]

Mr. Hill said the Annual Daily Valued Funds Report noted two immaterial errors in 2010.

The Audit Committee discussed the Board's policy on quiet periods. Ms. Whitmarsh committed to increasing the visibility of quiet period information in her monthly report. Additional education was requested, specifically relating to differences between private equity investment proposals and public equity or other manager procurements under consideration.

Mr. Hill reported the Committee also conducted an annual performance evaluation of the Internal Audit Director.

### **Global Proxy Voting Guidelines**

Mr. Hill said staff has explored ways the WSIB can more actively manage its non-U.S. proxy voting. Originally, staff proposed voting international proxy ballots in-house, similar to what is done with U.S. companies, but the cost and complexity of the global equity portfolio made that plan unworkable. Staff then developed new Global Proxy Voting Guidelines, which the Committee believes is a good compromise. Staff proposes that global equity fund managers continue to vote the WSIB's non-U.S. proxies according to their own guidelines, and provide regular reports on how ballots are voted. Using the WSIB's new guidelines and research on international proxy voting issues provided by Glass Lewis, staff will monitor how managers are voting to ensure their decisions are generally consistent with WSIB policy.

**Mr. Hill moved that the Board adopt the Global Proxy Voting Guidelines. Treasurer McIntire seconded, and the motion carried unanimously.**

## **PRIVATE MARKETS COMMITTEE REPORT**

Mr. Masten reported the Private Markets Committee met on April 7 and considered two investment recommendations.

### **Providence Equity Partners VII, L.P.**

**Mr. Masten moved that the Board invest up to \$300 million, plus fees and expenses, in Providence Equity Partners VII, L.P., subject to continuing due diligence and final negotiation of terms and conditions. Treasurer McIntire seconded the motion.**

Mr. Masten said the fund will have a target size of \$6 billion, and will pursue investment opportunities in the media, entertainment, communications, and information services industries on a global basis. The WSIB has invested in one prior Providence fund. The proposed investment is consistent with the 2011 private equity annual plan approved by the Board in February 2011 and the model portfolio approved by the Board in 2010. He said the recommendation is based, in part, on Providence's strong historical performance; focused, sector-driven investment strategy; global fund focus; and large experienced investment team with deep domain expertise in the firm's target sectors.

**The above motion carried unanimously.**

### **Prosperitas Real Estate Partners III, L.P.**

**Mr. Masten moved that the Board invest \$75 million, plus fees and expenses, in Prosperitas Real Estate Partners Fund III, L.P., subject to continuing due diligence and final negotiation of terms and conditions.**

Mr. Masten reported this is a \$750 million fund that will investment in all types of real estate in Brazil, with a strong focus on the industrial and retail sectors. The WSIB has invested in two prior Prosperitas funds, and, while not fully realized at this point, they have provided good returns to date. The proposed investment is consistent with the 2011 real estate annual plan approved by the Board in December 2010. He said the recommendation is based, in part, on Prosperitas' strong historical performance, attractive investment strategy, deal sourcing advantage, and quality investment team.

**Treasurer McIntire seconded, and the motion carried unanimously.**

Chair McElligott 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 Board would continue its executive session for agenda item 10a to review and discuss the performance of a public employee. He said the executive session was expected to last until about 1:00 p.m., at which time the Board would reconvene in open session.

[The Board went into executive session at 1:31 p.m.]

## **CTF COUNTRY-INDUSTRY AND ISSUER CONCENTRATIONS REVIEW**

### **ADMINISTRATIVE COMMITTEE REPORT**

#### **Executive Director's Evaluation**

[The Board reconvened in open session at 1:33 p.m.]

**Treasurer McIntire moved the Board accept the Executive Director's evaluation as written. Ms. Schurke seconded the motion.**

Chair McElligott reported the Board agreed Ms. Whitmarsh does an excellent job, and represents both the Board and staff well. He thanked Ms. Whitmarsh for her efforts.

**The above motion carried unanimously.**

**Assistant Attorney General's Report**

Mr. Dietrich had nothing to report.

**OTHER ITEMS**

There was no further business to come before the Board and the meeting adjourned at 1:32 p.m.

  
Patrick McElligott  
Chair

ATTEST

  
Theresa J. Whitmarsh  
Executive Director