

WASHINGTON STATE INVESTMENT BOARD
Board Meeting Minutes
January 19, 2012

The Washington State Investment Board met in open session at 9:37 a.m. in the boardroom at 2100 Evergreen Park Drive SW, Olympia, Washington.

Present: Treasurer Jim McIntire, Chair
George Masten
Judi Owens

Teleconferencing: Mike Ragan, Vice Chair
Steve Hill
Bill Longbrake
Patrick McElligott
Richard Muhlebach
Bob Nakahara
David Nierenberg
Natasha Pranger
Judy Schurke
Jeff Seely

Absent: Senator Lisa Brown
Representative Sharon Tomiko Santos

Also Present: Theresa Whitmarsh, Executive Director
Gary Bruebaker, Chief Investment Officer
Victor Moore, Chief Operating Officer (via teleconference)
Liz Mendizabal, Institutional Relations 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 (via teleconference)
Tom Ruggels, Senior Investment Officer – Private Equity (via teleconference)
Diana Will, Senior Investment Officer – Tangible Assets
Janet Kruzal, Assistant Senior Investment Officer – Private Equity (via teleconference)
Kristi Haines, Executive Assistant

Steve Dietrich, Attorney General's Office

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

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

ADOPTION OF MINUTES

Mr. Masten moved to adopt the December 15, 2011, Board meeting minutes. Ms. Owens seconded, and the motion carried unanimously.

PUBLIC COMMENT

There was no public comment.

COMMITTEE ASSIGNMENTS

Chair McIntire said he spoke with all Board members and there was no desire from anyone to change their current Committee assignment. He said the Governance *ad hoc* Committee plans discussion on the process, rotation, and responsibilities surrounding Committee assignments. He recommends keeping the current assignments as is.

Ms. Owens requested a copy of the Committee assignments.

Treasurer McIntire moved the Board accept the Chair's recommendation to leave the Committee assignments as is. Mr. Masten seconded, and the motion carried unanimously.

EXECUTIVE DIRECTOR'S REPORT

Ms. Whitmarsh reported the Governor reappointed Ms. Pranger to the Board for a three-year term effective January 1, 2012. Ms. Owens' and Mr. Ragan's Senate confirmations are also scheduled. She said the Private Markets Committee and Governance *ad hoc* Committee would both meet February 2, and the February Public Markets Committee is cancelled. Mr. Lerch, WSIB Research Director, was asked to serve as interim Executive Director of the Economic Forecast Council until a replacement for Arun Raja is hired.

ADMINISTRATIVE COMMITTEE REPORT

Chair McIntire said the Administrative Committee met earlier this morning to hear presentations from Ms. Whitmarsh on strategic plan themes and Mr. Moore on resource planning, which is a starting point for budget discussions. He said charts presented show preliminary resource needs of an additional \$7.9 million and 16 FTEs for the 2013-15 biennium and an additional \$1 million and 7 FTEs for the 2015-17 biennium. The Committee also reviewed a 2012 schedule of budget-related events leading up to the 2013 Legislative Session. Ms. Whitmarsh will present the 2012 Strategic Plan at the February Board meeting.

Treasurer McIntire said staff from the Office of the State Treasurer (OST) presented a proposal to shift some of the funds WSIB is currently investing to OST's management. Transferring the cash accounts to OST would better align agency investment resources and improve earnings of the cash funds. Proposed legislation was drafted to move 11 separate cash accounts to OST. None of the cash accounts are pension funds, with the exception of a small judicial retirement fund, which is on a cash basis.

Treasurer McIntire moved the Board support the proposed legislation regarding cash management transfer. Ms. Owens seconded the motion.

Treasurer McIntire said a complete list of the accounts to be transferred was emailed to Board members this morning. Ms. Whitmarsh said staff had worked closely with OST on the proposal. The accounts to be transferred are externally managed cash accounts and there is no advantage to have the WSIB invest the funds. She reported that stakeholders were contacted and had no issues with the proposal.

The above motion carried unanimously.

RETIREMENT CTF ASSET ALLOCATION POLICY REVISION

Ms. Will said staff is requested revisions to the Retirement Commingled Trust Fund (CTF) Policy to incorporate changes the Board had voted on and some other administrative updates. Page 3 updates the anticipated year end targets in line with the private equity and real estate annual plans. Page 4 updates the equity benchmark, and remaining changes replace “global equity” references to “public equity.” This administrative change clarifies terminology with managers and is consistent with other asset classes, as each class invests globally. The changes make it easier to understand the policy refers to public equity investing.

Ms. Owens moved the Board approve the proposed revisions to the Retirement CTF Asset Allocation Policy 2.10.050. Mr. Masten seconded, and the motion carried unanimously.

PRIVATE MARKETS COMMITTEE REPORT

Mr. Masten reported the Private Markets Committee met on January 6 to conduct the 2012 private equity annual planning session.

Chair McIntire 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 remain in executive session to also discuss litigation or potential litigation with legal counsel since public knowledge regarding the discussion is likely to result in an adverse legal or financial consequence to the WSIB. He said the executive session was expected to last until about 10:10 a.m., at which time the Board would reconvene in open session to consider a motion on item 8-B, 2012 Private Equity Annual Plan.

[The Board went into executive session at 9:55 a.m., and reconvened in open session at 10:49 a.m.]

Mr. Masten moved the Board adopt the confidential 2012 Private Equity Annual Plan that was presented and discussed in executive session. Ms. Owens seconded, and the motion carried unanimously.

[The Board briefly recessed at 10:50 a.m., and reconvened in open session at 11:04 a.m.]

ECONOMICALLY TARGETED INVESTMENTS ANNUAL REPORT

Ms. Kruzel highlighted the primary objective of the Board's Economically Targeted Investments Policy is to produce investment return to pension fund assets with possible collateral benefits to the regional economy. Staff reports annually on regional investment activities and the investments of WSIB general partners (GPs) in Washington State. She said policy implementation remains focused on collaboration and relationships. She reported investments were up over the past year for the U.S. in both deals and dollars, but down in both the Northwest and Washington State. However, Washington continues to capture about 75 percent of both deals and dollars in the Northwest, similar to prior years. Ms. Kruzel presented a chart of the 19 largest Puget Sound venture and private equity firms that had offices in Washington in 2010. These 19 firms have \$14.2 billion under management and invested \$688 million in 2010 with \$141 million of that going into 61 Washington deals, verifying that there is capital accessible in the state. She said the other key force in the environment is regional organizations that support and advance entrepreneurs and companies in Washington State. She described the background and services of some of the regional organizations; a number of the organizations have outreach to women and minorities.

Ms. Kruzel reported the annual poll of WSIB GPs showed fairly consistent activity. All 56 GPs polled reported on their activity. Thirty-eight looked at least 1 Washington deal; only 4 of the 38 were Washington-based; the 38 GPs looked at over 1,500 deals. Thirteen GPs completed 25 deals this year. There is still a strong number of GPs coming to Washington to review deals. Even the deals not pursued were reviewed and had GP access. These results confirm Washington continues to earn interest and access to top GPs.

Ms. Kruzel reported on the value of Washington investments in the WSIB portfolio, which represents 1.7 percent of the CTF. As a point of reference, Washington GDP is 0.50 percent of the WSIB Investable Universe GDP. The value of Public Equity investments is up over 7.5 percent compared to 2010 and Fixed Income is up 8.7 percent. Real Estate and Tangible Assets were down 10.6 percent; however, Private Equity was up 20.2 percent, made up of \$93.9 million new investments, less \$89.7 million returned in distributions, plus nearly \$23.6 million net appreciation.

She provided a recent example of a Washington company financing that involved money from WSIB through one of our GPs. This company achieved a \$25.8 million round of financing from 3 GPs, one in Washington and two from outside the state. WSIB invested in the Washington GP which contributed \$10 million or 38.8 percent of the total financing. WSIB's portion was \$1.58 million or about 6 percent of the total funding. The focus tends to be on the \$1.58 million WSIB contributes; however, the funding to the company also included an additional \$8.42 million from WSIB's GP and \$15.8 million from 2 GPs from outside Washington. Importantly, the Washington company received a total of \$25.89 million.

Since 1992, the WSIB has invested \$176.2 million in Washington based investments that have been fully realized. Those investments have returned \$156.9 million or 0.89x multiple of invested dollar—89 cents for each dollar invested. For comparison, in the total portfolio, the multiple for exited investments is 2.4x. Ms. Kruzel performed an industry analysis of losses last year at Mr. Masten's request: 4 of the 8 industries representing 44.5 percent of the invested dollars returned less than cost. The other 4 industries returned approximately 1.3x cost.

PUBLIC EQUITY HEDGING DISCUSSION

Mr. Lerch gave a presentation on hedging public equity risk. He described hedging as something to help offset risk or uncertainty, similar to buying insurance. The WSIB bears the risk currently when the market goes down, so is self-insuring, but also gets all returns when markets go up. The price for hedging is more expensive when there is more uncertainty in markets. Market conditions can be hedged either continuously or selectively. The tradeoff is reduced risk or uncertainty at the cost of reduced upside potential and greater complexity. The Board had previously decided to bear currency risk as a long-term investor that believes in mean reversion. The Board also has decided not to hedge the pension liabilities and accept the mismatch risk to provide for higher returns.

[Mr. McElligott was no longer in attendance via teleconference at 11:32 a.m.]

Mr. Lerch noted there are many different potential hedging strategies including use of derivatives, allowing public equity managers to hold more cash, reducing public equity holdings, and other strategies. These include buying or selling options that provide the right to sell something at a future date at a fixed price or require future sales at a fixed price. He described option components and premiums, and provided options examples using the MSCI ACWI and the S&P 500 including the premiums for various hedging strategies and hypothetical market return outcomes for hedged and unhedged portfolios over a static one year period. Mr. Lerch described several option-based strategies such as buying modified collar, covered calls, and equity replacement hedging strategies, and selling insurance instead of buying. He said timing greatly affects whether a hedging strategy looks good or bad.

In summary, Mr. Lerch said the benefits, costs, timing, basis risk, portfolio size, and asset allocation should be considered in making hedging decisions. Just thinking about whether or not to hedge is a worthwhile exercise because it sharpens how to think about investing and asset allocation.

Mr. Masten complimented the presentation, but said he is against any hedging of the portfolio. Treasurer McIntire said he is interested in learning about what other public funds are doing and if there are any pattern changes over the past few years. Mr. Bruebaker said he has not participated in any discussion of larger funds employing the mechanisms discussed during today's presentation, but funds have hedged by other means through percentages of asset allocations. Treasurer McIntire pointed out that asset allocation shifts can occur at precisely the wrong time. Ms. Whitmarsh said that European and Canadian funds are very actively engaged in the strategies because they must match assets to liabilities on a shorter time horizon.

Treasurer McIntire said the challenge is anticipating events and timing, and it can cost you. Mr. Longbrake pointed out the presentation suggests advantages of being an insurance seller rather than an insurance purchaser. He suggested conducting annual stress testing on the portfolio, like the Federal Reserve does, to ascertain what consequences could affect the portfolio, and then determine if the nature of those consequences is worth hedging. Mr. Bruebaker said staff is working on such an analysis through the data warehouse. He and Mr. Paroian have also discussed ways the WSIB could sell insurance in a manner that matches with points at which WSIB rebalances the portfolio anyway. The premiums from selling the

insurance could benefit the CTF. Ms. Owens and Mr. Masten requested the Board discuss that strategy further in the future. Treasurer McIntire said he would like to hear about any benefits and resources required regardless of whether it may or may not have substantial value. He would also like staff to do the stress testing analysis.

[The Board briefly recessed at 12:10 p.m., and reconvened in open session at 12:32 p.m.]

FIXED INCOME REVIEW AND OUTLOOK

Mr. Kennett introduced his Fixed Income annual review for 2011 and 2012 outlook. During 2011, the big story was the European debt crisis. Interrupted supply chains, oil market disruption, unemployment, and volatile markets were other global events during the year. Mr. Kennett reviewed activities within the U.S., including the downgrade of the U.S. debt rating, increase of the debt ceiling, failure of the super committee, a second round of quantitative easing, and interest rate declines. He said the fourth quarter GDP estimates are between 3-4 percent.

For 2012, Mr. Kennett believes the global recovery will remain fragile, with potential issues in Europe, a slowdown in China, sluggish U.S. growth, and other political and social risks. Growth will continue to be led by emerging markets. For the U.S., he anticipates the economy will be better than those of Europe and Japan driven by capital spending and exports. He believes fiscal consolidation will slow growth, inflation will slow, labor markets will remain weak, and housing will stabilize despite foreclosures weighing on pricing. He expects interest rates to remain low.

Mr. Kennett discussed his outlook for emerging markets, which he expects to have faster growth, lower debt, and lower fiscal deficits compared to the developed world. He shared a global GDP forecast by country.

Within fixed income markets, he anticipates treasury yields will remain low, the Fed will remain accommodative, and wider corporate spreads due to less liquidity. He believes credit quality has peaked, high yield will underperform, and returns will be in the low single digits.

Mr. Kennett discussed macroeconomic risks within the Euro zone, China, and Japan. He expects the fixed income portfolio will remain overweight credit, with a focus on emerging markets and a short to neutral duration to the index. He indicated two specific risks to the retirement fund portfolio are liquidity concerns, similar to what occurred in 2008, and dollar appreciation as the portfolio is overweight non-U.S. dollar bonds.

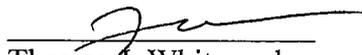
The fixed income portfolios have \$27.7 billion in assets under management, with retirement representing over 44 percent of that and Labor and Industries' (L&I) asset classes just over 40 percent. Mr. Kennett reported that 55.5 percent of the portfolios are invested in credit so staff spends significant time on that sector. For the year, the retirement portfolio underperformed by 178 basis points, but did very well over the 3-, 5-, and 10-year periods. He reported the L&I funds' goals and risk constraints differ from those of the retirement fund. Staff and the consultant meet quarterly with L&I to discuss returns. He said the L&I funds underperformed for the year, entirely due to treasuries.

OTHER ITEMS

There were no further items to come before the Board, and the meeting adjourned at 1:34 p.m.


James L. McIntire
Chair

ATTEST


Theresa J. Whitmarsh
Executive Director