

WASHINGTON STATE INVESTMENT BOARD
Board Meeting Minutes
February 16, 2012

The Washington State Investment Board met in open session at 9:30 a.m. in the boardroom at 2100 Evergreen Park Drive SW, Olympia, Washington.

Present: Treasurer Jim McIntire, Chair
 Mike Ragan, Vice Chair
 Senator Lisa Brown (via teleconference)
 Judi Owens
 Bill Longbrake
 Patrick McElligott
 Richard Muhlebach
 Bob Nakahara (via teleconference)
 David Nierenberg (via teleconference)
 Natasha Pranger (via teleconference)
 Judy Schurke
 Jeff Seely

Absent: Steve Hill
 George Masten
 Representative Sharon Tomiko Santos

Also Present: Theresa Whitmarsh, Executive Director
 Gary Bruebaker, Chief Investment Officer
 Victor Moore, Chief Operating Officer
 Liz Mendizabal, Institutional Relations Director
 Steve Draper, Senior Investment Officer – Real Estate
 Bill Kennett, Senior Investment Officer – Fixed Income
 Phil Paroian, Senior Investment Officer – Public Equity
 John Graves, Assistant Senior Investment Officer – Tangible
 Assets
 Kristi Haines, Executive Assistant

 Steve Dietrich, Attorney General's Office
 Mike Augustine, Hamilton Lane
 Tara Blackburn, Hamilton Lane

[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. McElligott moved to adopt the January 19, 2012, Board meeting minutes. Mr. Ragan seconded, and the motion carried unanimously.

PRIVATE MARKETS COMMITTEE REPORT

Chair McIntire provided the Private Markets Committee Report in Mr. Masten's absence. He reported the Committee met on February 2 to consider four investment recommendations.

Oaktree Opportunities Fund IX, L.P.

Chair McIntire moved the Board invest up to \$400 million, plus fees and expenses, in Oaktree Opportunities Fund IX, L.P., subject to continuing due diligence and final negotiation of terms and conditions. Mr. McElligott seconded the motion.

Chair McIntire reported Fund IX is a non-control distressed debt fund with a target size between \$4 and \$6 billion. Fund IX will focus on investments in under-valued public bonds and bank debt of financially distressed companies in which value can be created through management of a bankruptcy reorganization or restructuring outside bankruptcy. Up to 50 percent of commitments can be invested outside of the U.S. and Canada. Since 1994, the WSIB has invested in ten prior Oaktree Opportunities funds and two of the Principal funds. The proposed investment is consistent with the Board-approved 2012 private equity annual plan and model portfolio. He said the recommendation is based, in part, on the firm's strong and experienced team, strong track record, successful investment strategy, strong deal flow, and fit in the WSIB's private equity portfolio.

The above motion carried unanimously.

KKR Asian Fund II, L.P.

Chair McIntire moved the Board invest up to \$400 million, plus fees and expenses, in KKR Asian Fund II, L.P., subject to continuing due diligence and final negotiation of terms and conditions. Ms. Owens seconded the motion.

Chair McIntire reported this pan-Asian private equity fund with a target size of \$4 billion to \$6 billion will pursue investments in large, industry-leading businesses in Asia, with a focus on six regions: Australia, Greater China, India, Japan, South Korea, and Southeast Asia. The WSIB and KKR have been investment partners since 1983. Over the past 29 years, the WSIB has committed a total of \$7.8 billion across 18 KKR-sponsored investments, including \$400 million to the KKR Asian Fund in 2007. The proposed investment is consistent with the Board-approved 2012 private equity annual plan and model portfolio. He said the recommendation is based, in part, on KKR's experienced team, operation and value creation resources, global franchise, successful track record in Asia, institutionalized processes, and fit in the WSIB private equity portfolio.

The above motion carried unanimously.

The Fifth Cinven Fund, L.P.

Chair McIntire moved the Board invest up to €192 million, plus fees and expenses, in The Fifth Cinven Fund, L.P., subject to continuing due diligence and final negotiation of terms and conditions. Mr. Ragan seconded the motion.

Chair McIntire reported this European buyout fund with a target size of €5 billion will continue Cinven's proven strategy of investing in sector-focused, large buyout transactions across Europe in six industry sectors. Since 1996, the Board has invested in four Cinven funds. The proposed investment is consistent with the Board-approved 2012 private equity annual plan and model portfolio. He said the recommendation is based, in part, on Cinven's experienced investment team, consistent investment strategy, long-term track record, financing and portfolio teams, and single investment focus.

The above motion carried unanimously.

Hemisferio Sul Investimentos Fund IV, L.P.

Chair McIntire moved the Board invest up to \$50 million, plus fees and expenses, in Hemisferio Sul Investimentos Fund IV, L.P., through Emerging Markets Fund of Funds II, LLC, subject to continuing due diligence and final negotiation of terms and conditions. Mr. Ragan seconded the motion.

Chair McIntire reported this Brazilian real estate fund is capped at \$650 million. The fund will be opportunistic and focus on industrial and retail opportunities across Brazil. Hemisferio Sul Investimentos was formerly known as Prosperitas Real Estate Partners. The name was recently changed due to the departure of two of the Prosperitas founding partners. Since 2006, the WSIB and EMFOF have invested \$250 million across three Prosperitas funds. He said the recommendation is based, in part, on Hemisferio Sul's quality leadership and investment team, including their strong reputation, deal sourcing advantage, and disciplined investing approach.

The above motion carried unanimously.

PUBLIC COMMENT

There was no public comment.

ADMINISTRATIVE COMMITTEE REPORT

Vice Chair Ragan provided the Administrative Committee Report on behalf of Chair McIntire. He said the Committee met February 16, and received the quarterly budget update. Currently, it is estimated the appropriated budget will be under spent by \$581,000 for fiscal year 2012, and the non-appropriated budget will end the fiscal year under spent by \$31 million. The Committee was also briefed on the proposed 2012 Strategic Plan.

Strategic Plan

Ms. Whitmarsh introduced the 2012 Strategic Plan discussion. She noted elements of the plan are not new as members have been very involved in strategic plan setting and development through discussions beginning at the July planning session, participation in the asset plan annual planning sessions, and through progress of the Governance *ad hoc* Committee. The Strategic Plan is a compilation of Board discussions over several years and internal staff discussions. The framework of the plan is developed with value, support, and capacity initiatives, built upon a foundation of a skillful Board. Ms. Whitmarsh said each of the three areas of the framework is stressed in this year's plan, and the long-range plan is organized around relieving stress points. In developing the plan, Ms. Whitmarsh assumed the WSIB will continue its past success of being ahead of the market, showing a willingness to be different than peers, and following a disciplined approach to decision-making. Future challenges are the complexity of the market; competition for deals, partners, and staff; and increasing geopolitical and reputation risk. She said success is people, resource, and reputation dependent. The plan has a significant focus on resources necessary for investment, organizational, and governance strategies.

Value initiatives focus on what the WSIB will do to ensure it delivers exceptional returns, which will be more challenging given the macro-economic headwinds, stiff competition for managers and deals, manager fee structures, and the volatile dynamics of emerging markets.

Mr. Bruebaker commented on the challenge with equity market investment returns. Mr. Seely said the WSIB needs to be inspired to think creatively about strategic investment categories, specifically in light of changes within private markets investing. Mr. Longbrake noted growth rates and inflation are factors in public equity returns. Chair McIntire said the return assumption is expected to ramp down. Mr. Nierenberg observed these factors point to the importance of a continued emphasis on emerging markets. The capital markets environment, volatility of returns, and slowing growth makes liquidity move around, which should create structural opportunities for investors such as the WSIB.

Ms. Whitmarsh noted the Board had already approved the 2012 asset class plans. She focused her remarks on challenges in implementing the plans. Within Private Equity, there is stiff competition for managers and deals, and the money entering the markets is often irrational which drives up prices. It is becoming increasingly harder to align interest with managers. The WSIB remains committed to private equity, but certain fee structures may not be acceptable. The challenge going forward will be when to walk away from deals. Mr. Longbrake asked about partnering with other pension funds. Mr. Bruebaker responded the WSIB already partners with other funds on significant issues, and works to strengthen relationships to get better terms. Mr. Nierenberg said the budget plays a part in private markets investing. The WSIB has been conservative about investing with younger private equity organizations because of the resources involved in conducting the significant due diligence required. Increased resources would allow the WSIB to branch out. Mr. Bruebaker noted co-investment and direct deal strategies pay off, but WSIB's salary structure does not attract the necessary skill sets.

Ms. Whitmarsh said emerging markets continue to be an important emphasis, but noted capacity limits access and increased travel does take a physical toll on staff. Core strategies will continue globally and new strategies will be sought in the margins. Ms. Whitmarsh said the tangible assets class is gearing up now that program staff is in place, and a significant effort will be made over the next few years to build that out.

Ms. Whitmarsh said another challenge within private markets is that returns will likely be lower going forward. Large and mega buyouts are a significant portion of the portfolio and return expectations for those strategies are lower, so the forward emphasis will be on medium and small corporate finance, distressed, and Asia opportunities. But, there is also a limited pool of quality private equity managers in these strategies and the Board's large allocation to private equity requires us to put a significant amount of money to work each year, necessitating the continued reliance on large and mega buyout strategies. The Board will want to consider these issues in its next asset allocation discussion. Senator Brown said she appreciates the focus on global opportunities and consideration of the changing environment.

[Senator Brown was no longer in attendance via teleconference at 10:20 a.m.]

Ms. Whitmarsh said challenges within Real Estate are seeking out good real estate operating company managers and keeping the team together, as the WSIB runs a completely unique strategy compared to its peers. Other funds are likely to seek out WSIB's talent.

The challenge within Public Equity is its dependency on researching and pacing of the various strategies planned for implementation over the next several years. Additional resources would ramp up these efforts.

Within Fixed Income, staffing is the challenge. This internally managed asset class has experienced more turnover than any of the other asset classes, as staff gains experience and moves on either for better pay or relocates to financial market cities.

Ms. Whitmarsh grouped asset class strategies with the highest return impact to beneficiaries and their correlation to additional FTEs. She noted a number of strategies can be implemented with existing staff, but some strategies require additional staff in both investments and operations. Mr. McElligott pointed out the amount of time the Board has spent discussing hedging strategies, their return impact, and resource requirements to implement.

Ms. Whitmarsh discussed the Board's current hierarchy for risk discussions and how it could be enhanced to further examine total portfolio risk in a macro-environment context. She said the Board has not explicitly defined its risk appetite at the total portfolio level and the plan is for the Audit Committee to discuss an approach to that in 2012. Mr. Longbrake said the Board should take a long-term view of risk so it does not get sucked into the news of the moment. Chair McIntire said a variety of stress testing would be useful. Mr. McElligott said he looks to the staff and non-voting members to provide him guidance in risk considerations. Staff is ultimately responsible for what goes on and the Board's job is to monitor that.

Support initiatives focus on how the WSIB conducts itself in the marketplace and with stakeholders so it receives support to fulfill its mission. Ms. Mendizabal summarized the Governance *ad hoc* Committee's progress in developing the WSIB's story for communicating with beneficiaries, legislators, constituency groups, and the media to increase understanding about the WSIB and how much the agency contributes to state pension and other funds for which it invests. Ms. Schurke commended the summary but suggested the story should enhance messages to better describe the growing complexities managing investments in the global marketplace.

[Ms. Pranger was in attendance via teleconference at 10:45 a.m.]

Board members stressed the importance of communicating the WSIB's purpose, accomplishments, and operating environment. Ms. Whitmarsh said there is a tendency for the Legislature to focus on the WSIB's appropriated budget, which represents only 4 percent of the total budget, rather than the 96 percent non-appropriated portion comprised of investment earnings. Mr. Bruebaker developed an illustration to demonstrate the cost savings achieved through internal versus external management. Staff will continue to develop comparisons to show cost savings in considering restructuring or internally managing strategies.

Ms. Whitmarsh said staff will continue its focus on corporate governance, which is of importance to constituents, and selectively lend WSIB's voice with certain governance initiatives.

Capacity initiatives focus on how to build the WSIB into an organization that can execute on its plans and programs. Ms. Whitmarsh noted Mr. Moore presented a preliminary 6-year resource plan at the January Administrative Committee meeting. The Board will have an opportunity to consider resource needs in its budget request process. Mr. Moore reviewed the anticipated resource needs to research and build out the asset classes. He said 8 FTEs are contemplated for the 2013-15 biennium, and an additional 5 FTEs for the 2015-17 biennium. There are also resource needs to enhance risk management and control, convert the accounting book of record to the custody bank, and support investment operations within information technology, trade settlement and cash management, and performance reporting for a total FTE increase of 16 in 2013-15 and 7 in 2015-17.

Mr. Moore said an important budget matter is the WSIB's salary structure. The salary survey conducted in 2010 showed the WSIB compensation level was 22 percent behind its peers, and preliminary data shows WSIB is further behind in 2012. This is a challenge in attracting talent. Ms. Whitmarsh said the Committees and Board have major decisions to consider in the coming months—the proposed budget will be presented at the June Board meeting. The new salary study is scheduled for presentation at the April Administrative Committee and Board meetings, and a decision will need to be made on whether or not to adopt it so that it can be included in the budget request. If the Board does not approve it, the Office of Financial Management will remove it from the WSIB's budget request. Ms. Whitmarsh said the Board may also want to consider whether it wants to pursue department-request legislation to amend the Board's salary setting statute.

Mr. Nierenberg asked if WSIB's resource needs will be discussed with gubernatorial candidates. Ms. Whitmarsh said the current plan is for staff to engage in discussions after the election.

Mr. Moore said the Board did not adopt the 2010 salary survey. Ms. Whitmarsh said even if the Board had adopted the survey, it could not have been implemented due to the salary freeze in place at the time. Chair McIntire shared the difficulty in adopting the survey at that time due to the weak economic forecast. He said there is a lot of ground work to be done before a compensation structure change can be proposed. Ms. Whitmarsh remarked the salary setting authority is appropriate, but the appropriation authority restricts implementation. She said the inability to pay an average salary is hard on staff and the management team works hard to keep morale high. Mr. McElligott pointed out the Board can adopt the survey without implementing

it. Ms. Owens and Messrs. Nierenberg and Ragan spoke in support of acting on the salary survey.

Ms. Whitmarsh noted additional staff initiatives for 2012 include the custody bank conversion, risk management tool development, information technology and valuation projects, and budget development. The Governance *ad hoc* Committee will continue its work to ensure the Board functions at its optimal level.

Mr. Ragan moved the Board adopt the 2012 Strategic Plan. Ms. Schurke seconded, and the motion carried unanimously

[The Board briefly recessed at 11:30 a.m., and reconvened in open session at 11:40 a.m.]

Governance Committee Report

Ms. Owens reported the Governance *ad hoc* Committee met February 2 to review progress on developing the WSIB story, and other work assignments relating to the Chair's role, new Board member development through mentorship, enhancing the Board's current evaluation process, and a suggestion that the Board should develop WSIB principles. She said the Committee believes the Board Chair should engage with appointing authorities to discuss impending voting Board member vacancies, and asked staff to develop a Board member position description for the Chair's use in those discussions. The Committee reviewed and approved the draft at its February 2 meeting. The Committee also discussed a number of ways to improve the Board's evaluation process. One of the proposals is to add annual Board member self-evaluation discussions with the Board Chair. Ms. Owens said a proposed revision of the Charter of the Board Chair is attached to reflect both proposed changes in practice.

Ms. Owens moved the Board adopt the Board member position description and the proposed revisions to the Charter of the Board Chair 1.00.160.

Mr. Ragan seconded the motion.

Mr. McElligott stated a concern that having the Chair communicate with appointing authorities could appear as though the Board is attempting to influence or restrain constituent group nominees. Chair McIntire said the intent is to communicate the nature and ongoing concerns of the Board, and to provide appointing authorities a sense of background and information on needs, with an attention to continuity and movement. Ms. Whitmarsh said the proposal is not intended to circumvent the appointment process but to educate appointing authorities on the urgency in filling vacancies and the time commitment involved.

Ms. Owens withdrew her motion.

Chair McIntire said the matter would go back to the Governance *ad hoc* Committee for further consideration.

Ms. Owens said the Committee asked the Executive Director to obtain Rick Funston as a consultant to assist in governance work, specifically, in developing WSIB Principles. Staff will come back to the Administrative Committee with a proposal from Mr. Funston in April.

EXECUTIVE DIRECTOR'S REPORT

Ms. Whitmarsh reported the March Private and Public Markets Committee meetings were cancelled. The Audit Committee will meet March 6. The Board's annual planning session will be held July 17-19 at Suncadia in Cle Elum. Ms. Whitmarsh reported staff is finalizing a lease at Two Union Square in Seattle for telecommunicating and conference space effective April 1.

[Mr. Nakahara was in attendance via teleconference at 11:51 a.m.]

QUARTERLY DISCUSSION OF MARKETS

Portfolio Discussion

Mr. Bruebaker announced it was a good fourth quarter, but not a good year. The Commingled Trust Fund (CTF) was up 2.39 percent for the quarter, but only 2.35 quarter for the year. The equity markets were up 7.1 percent for the quarter as of December 31. Since inception the portfolio is up 8.31 percent as of December 2011. The Implementation Value Added (IVA) analysis showed outperformance by 280 basis points (bps). The allocation decision was hurt by an overweight in private equity by 21 bps and underweighting in public equity by 19 bps. The manager decision was hurt by Real Estate managers' underperformance by 65 bps, but helped by the Fixed Income internal management team, which beat the index by 81 bps for the quarter. Private equity managers beat by 358 bps.

Mr. Graves provided an update on the propriety internal resource equity strategy. He said the program objectives are to have an economic growth investment, to help the CTF, and mitigate inflation by investing in commodity producers. The strategy is up 9.2 percent for the quarter, outperforming the benchmark by 2.3 percent. Since inception, however, it has underperformed the benchmark slightly by 0.3 percent due to volatility, but he said it is a buy and hold strategy for the long-term. He complimented the operations staff for settling over 100 trades in 13 different currencies.

Fixed Income

Mr. Kennett said the retirement CTF outperformed by 81 bps, with a 2.26 percent return for the quarter ending in September. Risky sectors performed well. Government securities underperformed by 39 bps due to duration and credit outperformed by 111 bps. The returns of the Labor and Industries' accident, medical aid, and pension reserve funds were below those of their respective CMIs. Credit did well. The Intermediate Credit Bond Fund outperformed by 58 bps. The Permanent Funds underperformed by 35 bps for the quarter as they are transitioning to equity.

For the outlook, Mr. Kennett said the labor market has improved and the Fed announced it is not raising short term interest rates until 2014. In Europe, some countries are in recession and there is no agreement on Greece. He said Portugal may need a second bailout, China is slowing, but emerging markets are still the bright spot.

Public Equity

Mr. Paroian said the global markets were down 7.8 percent, U.S. was flat, emerging markets were down 19.5 percent, and frontier markets were down 22 percent for the calendar year 2011. The consumer staples and healthcare were the best performing sectors; telecoms were flat; and materials, financials, and industrials were all down. He said programs and managers all behaved as expected, providing significant downside protection. U.S. passive and non-U.S. both

outperformed, with emerging markets program outperforming by 300 basis points; i.e., they fell by far less than the broad equity markets during the challenging markets at the end of the year. The portfolio of new global equity managers hired in June 2011 have outperformed by about 200 bps since they were put in place and the total public equity program outperformed 133 bps for the year compared to the benchmark. Within Plan 3 and the Deferred Compensation Program, the passive only options are within targets as expected. For the market outlook, there are a lot of unresolved negatives and managers are positioning defensively. Staff continues to expect that the program should protect during down equity markets. In rapidly rising equity markets, it should produce positive returns close to the benchmark returns, but is expected to lag somewhat in that environment.

Real Estate

Mr. Draper provided the real estate third quarter report. He said anything with exposure to the Euro, distress, and healthcare declined during the quarter. The one-year return was about 12 percent and the one-year income return was 7.5 percent. He noted that this level of income yield will likely be lower going forward as values continue to recover. He said that where we have the highest quality properties we are experiencing attractive returns. The real estate operating companies' strategy has outperformed by 620 bps over the past five years, spanning the economic downturn. The portfolio's 10-year return is net 9.2 percent with 6.2 percent of that coming from income.

Private Equity

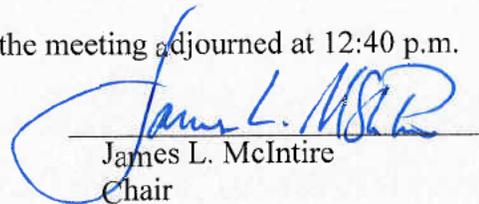
Ms. Blackburn provided a high level third quarter summary for the private equity markets. She said the first half of 2011 had the most activity with deal numbers consistent quarter to quarter. Global LBO is picking up and the capital overhang in private equity is going down. The activity is fairly good, depending on the debt market. She said that fund raising has slowed.

Ms. Blackburn described the speed at which older deals are getting liquidated. Distributions spiked in the fourth quarter. The WSIB portfolio has \$1.5 billion in net value and \$618 million in market value.

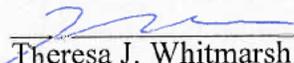
In response to Mr. Longbrake's question, Mr. Bruebaker said he feels good about the strategy and positioning of the portfolio. Mr. Bruebaker provided some statistics from *Pensions & Investments*, which show the WSIB is the seventh largest pension fund in real estate within the U.S., second largest outside the U.S., fourth largest in private equity in the U.S., seventh largest in 457 plans and largest in 401A. Treasurer McIntire asked if Mr. Bruebaker would email the statistics to the full Board.

OTHER ITEMS

There were no further items to come before the Board, and the meeting adjourned at 12:40 p.m.


James L. McIntire
Chair

ATTEST


Theresa J. Whitmarsh
Executive Director