WASHINGTON STATE INVESTMENT BOARD
Board Meeting Minutes
May 17, 2012

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

Present:	Treasurer Jim McIntire, Chair Bill Longbrake George Masten Patrick McElligott Richard Muhlebach Bob Nakahara David Nierenberg (via teleconference) Judi Owens Natasha Pranger Representative Sharon Tomiko Santos (via teleconference) Jeff Seely
Absent:	Mike Ragan, Vice Chair Senator Lisa Brown Steve Hill Judy Schurke
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 Tom Ruggels, Senior Investment Officer – Private Equity Diana Will, Senior Investment Officer – Tangible Assets Kristi Haines, Executive Assistant Steve Dietrich, Attorney General's Office George Roberts, Kohlberg Kravis Roberts Mike Michelson, Kohlberg Kravis Roberts Neil Rue, Pension Consulting Alliance John Linder, Pension Consulting Alliance 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.

PUBLIC COMMENT
There was no public comment.

KKR PRIVATE EQUITY DISCUSSION
Messrs. Roberts and Michelson, Kohlberg Kravis Roberts (KKR), introduced themselves. Mr. Roberts commented on the 30-year relationship between the WSIB and KKR and changes since 1982. He discussed what is happening with Europe's economy, governments, and currency and shared his view on the potential impact to Germany should the Euro fail and the effect of austerity measures. He expects low growth due to issues with the European banking industry, which creates investment opportunities to be explored. Mr. Roberts relayed the Chinese believe consumption needs to increase in order to improve their economy, and they have the resources to do it. Japan's economy is growing and has had one of the best performing stock markets over the past 12 months. Korea, Singapore, Malaysia, and Southeast Asia are also strong. Within the U.S., Mr. Roberts said he believes the underlying strength of the economy is better than what is reported in the media. There have been slight improvements in businesses and uplifting in consumer confidence; manufacturing is returning. Mr. Roberts said he is optimistic about the U.S. economy and believes it is a good time to invest.

[Mr. Seely arrived at 9:40 a.m.]

Mr. Michelson said the WSIB has invested approximately $6.6 billion with KKR across 13 funds. KKR has returned approximately $8.5 billion in realized proceeds and created $5.7 billion in realized and unrealized profits for the WSIB as of March 31, 2012. Fund investments have generated a 19 percent net IRR, representing 850 basis points (bps) of outperformance compared to the S&P 500. He provided an update on KKR's team of professionals, described KKR's alignment of interest by investing along with limited partners, and attributes that differentiate KKR from other firms.

Mr. Michelson reported on performance within the North American private equity portfolio. Treasurer McIntire asked about the status of Energy Future Holdings (EFH). Mr. Michelson said EFH is based in Texas and will be hurt by the decline in natural gas prices. He said as natural gas futures' contracts expire, the company will be exposed to spot market pricing. KKR has written down the value to EFH and focused on its balance sheet to ensure maturities on debt are met. KKR is focusing on improving capital structures.

Mr. Michelson reported KKR has distributed or announced distributions of approximately $644 million in 2011 and 2012 to the WSIB. He described investment opportunities reviewed by KKR over the past 15 months and 10 investments resulting from that activity. The WSIB contributed $263 million for those new investments. He reported on performance of the Millennium Fund and 2006 Fund, and the current investment environment and outlook for North America.

Mr. Longbrake asked what KKR believes its most compelling challenges are. Mr. Roberts responded the U.S. and individual states' deficits are of concern in addition to managing risks associated to macro-economic issues. He said KKR is financially strong and will continue to be good stewards of Washington's money. Mr. Seely asked if KKR learned anything about financial institutions given recent crises. Mr. Roberts commented on the current situation at JPMorgan (JPM). JPM tried to hedge its risk to allow them to take more risk and provide capital to the markets at a lower cost. They were trying to manage their business and a number of issues resulted in a bad trade, but he believes the banking and financial systems need to have the ability to manage risks to control costs. Mr. Nakahara asked for comment on the health care industry. Mr. Michelson said the industry is an indispensable part of the economy but is undergoing very substantial change and having to adapt to the fact that, with an aging population, there will be more demand for health care service and someone has to pay for that. He said it is hard to determine how the health care reform act will affect the industry and people.

Chair McIntire thanked KKR for their presentation and the 30-year relationship with the WSIB.

[The Board recessed at 10:50 a.m., and reconvened in open session at 11:07 a.m.]

CAPITAL MARKET ASSUMPTIONS

Mr. Bruebaker said staff contracted with Pension Consulting Alliance (PCA) to develop the 2012 capital market assumptions analysis. Mr. Rue introduced himself and Mr. Linder of PCA. Mr. Rue said PCA worked closely with staff to become familiar with the current capital market assumptions, discuss results of assumptions run under a variety of scenarios, and develop base line numbers. WSIB staff also contacted other consultants for their thoughts on capital market assumptions to gain a consensus view of the markets. Mr. Rue introduced the proposed capital market assumptions across the asset classes. He explained the correlations, returns, and risks for each, with return and risk being the dominate drivers. He described arithmetic returns as reasonable estimates as to an asset class' expected return over a 1-year period and geometric returns representing a horizon (long-time) return which considers volatility of the asset class. The basic building blocks of developing capital market assumptions include estimating what inflation will be over the next 10 years and whether it is possible to capture a short-term return above inflation.

Mr. Rue said the proposed 2012 fixed income assumption is lower than last year due to low yields. In response to Mr. Longbrake's question about the methodology used to derive the rates, Mr. Linder said the historical return premium over cash is a data point, but a direct approach is also used in examining yield to directly estimate the forward-looking return of that index.

[Mr. Masten left the meeting at 11:26 a.m.]

Mr. Rue described how WSIB's allocations, expectations, and return assumptions are used to calculate the likelihood of reaching targets and the potential effects to the portfolio. The WSIB's fixed income portfolio is different from standard portfolios because it is more credit-oriented, and the proposed capital market assumptions were customized to account for WSIB's uniqueness. Mr. Longbrake commented on how critical it is to understand the starting assumptions and variability. Treasurer McIntire questioned when the 2012 risk and return assumptions were put together from the various consultants. Mr. Linder said PCA established their assumptions in January 2012, and other consultants' input was likely developed at the end of 2011. Mr. McElligott said he believes the assumptions are conservative. Mr. Bruebaker said the return assumption established by the Legislature will be 7.9 percent as of July 1, 2013, and he does not believe the assumptions are overly conservative. Mr. Rue said active management will be needed to reach an 8 percent return going forward. Ms. Whitmarsh described how the State Actuary uses the WSIB's capital market assumptions in developing a proposal to the Legislature for the return assumption.

[Representative Santos was in attendance via teleconference at 11:40 a.m., and left the meeting at 11:42 a.m.]

Mr. Longbrake suggested further Board education on the topic to understand the range of risks, to include a deeper dive on the building blocks that go into developing the capital market assumptions. Ms. Whitmarsh said the Board will review its asset allocation in 2013, and staff will plan education sessions leading up to the Board's decision.

Treasurer McIntire announced the Board will defer action on the capital market assumptions to the June Board meeting due to lack of quorum.

[The Board recessed at 11:55 a.m., and reconvened in open session at 12:20 p.m.]

EXECUTIVE DIRECTOR'S REPORT

Ms. Whitmarsh said the Private Markets Committee will meet in June. The WSIB will transfer nine short-term interest and cash funds to the Office of the State Treasurer on June 7. Recruitment continues for the Senior Investment Officer-Risk Management/Asset Allocation. She reminded members the WSIB has open procurements for an executive recruiting firm and pool of audit consultants.

QUARTERLY DISCUSSION OF MARKETS

Portfolio Discussion

Mr. Bruebaker reported it was a great first quarter for investment returns, up 6.7 percent for the quarter and 4.6 percent for the year despite equity markets being down by 6.2 percent. The since inception return was 8.52 percent as of April 30, 2012.

For the Implementation Value Added (IVA) benchmark, allocation decisions hurt the portfolio by 10 bps due to an overweighting in private equity and underweighting in public equity, but were helped by underweighting in Tangible Assets. Manager decisions helped the portfolio by 344 bps; with fixed income outperforming by 31 bps, private equity managers outperforming by 306 bps, and real estate managers outperforming by 21 bps. IVA performance over longer periods is back in favor. Public markets were up about 12 percent for the quarter, with the index for private equity being down about 7 percent—even with our managers outperforming the markets by being up 5 percent, we still lagged the bounce back in the public markets. Mr. Bruebaker said whenever public equity does well, private equity performance lags before catching up.

Fixed Income

Mr. Kennett reported the retirement fixed income portfolio outperformed by 146 bps for the quarter ended March 31. Sector quarterly returns from the Barclays Universal resulting in Treasuries returning negative 1.29 percent; long bonds went up 40 bps and the 10-year was up

30 bps in yield. For the current quarter, all of that has reversed; yields are now lower than they were at the beginning of the calendar year. In the first quarter, Treasuries were negative 1.29 percent, investment grade credit was positive by 2.04 percent, mortgage-backed securities were down .057 percent, and emerging markets returned 7.74 percent. Fixed income outperformed in every sector group. Mr. Kennett said the WSIB is short Treasuries, expecting rates to head higher, but it has not happened yet. The Fed is keeping rates low. Mr. Longbrake commented it is an intentional result of monetary policy to create a negative real rate (inflation-adjusted) of return. Mr. Kennett reported that government securities outperformed by 71 bps, credit outperformed by 85 bps, non-dollar bonds added to returns, and securitized outperformed by 35 bps. He said the fixed income portfolio has outperformed by 40 bps year-to-date.

Mr. Kennett reported the Labor and Industries' funds' returns were close to those of their Comparable Market Indices, with the Pension Reserve Fund above by 8 bps, and the Accident and Medical Aid funds below by 16 and 8 bps, respectively. Performance was hurt by underweighting to financials, which did well for the first quarter; the WSIB only carries high quality financials. The Intermediate Credit Bond Fund underperformed by 63 bps, also due to financials.

Mr. Kennett said economic numbers are mixed. He believes housing has finally stabilized, and the U.S. GDP will increase by 1 to 2 percent for the year. Others believe the U.S. GDP could be as high as 2.4 percent. Emerging markets are a bright spot. China is slowing but he does not think it will have a hard landing. He expects China, India, and Brazil to have GDP growth of 8, 7, and 3 percent, respectively. Mr. Kennett said the big question is how the situation in Europe will affect the rest of the world.

Public Equity

Mr. Paroian reported that public equity had a very strong first quarter. Global markets were up 12 percent, and U.S. markets were up 13 percent. Geographically, Spain and Portugal were the worst markets and Egypt was the best. In general, emerging markets were relatively strong performers. In the developed markets, information technology (IT) and consumer discretionary sectors were up 17 to 18 percent, and financials were up about 15 percent. Although all sectors had positive returns, the weakest sectors were utilities, telecoms, and energy. Within emerging markets, IT, consumer discretionary, healthcare, and industrials did well; energy and materials had the weakest performance.

The Commingled Trust Fund is underweight by 90 bps in the U.S. and overweight by 55 bps in emerging markets and 35 bps in developed non-U.S. markets—mostly in Europe. Mr. Paroian said almost every public equity manager is neutral to overweight in Europe. Market distress and dislocation has put pressure on all companies in these markets, including some very solid ones that are now very cheap. Managers are being selective about finding sustainable companies with strong fundamentals at discounted valuations and are increasing weights in Europe on a bottom-up basis.

Mr. Paroian reported that (on one panel discussion at a recent CFA conference) the consensus was the Euro will survive but not with all 17 participating countries, with Greece likely to exit first. Another presentation described the difficulty China faces in turning its economy around through increased consumer spending, as the current growth has been investment driven with the government doing most of the spending on infrastructure.

Mr. Paroian said the public equity portfolio is positioned to protect on the downside. Through April, the portfolio was behind its benchmark by 30 bps due mostly to the effect of a single manager whose portfolio faced extreme selling pressure after the departure of the lead portfolio manager. Fiscal year-to-date, the overall public equity portfolio is ahead of the benchmark by 67 bps. A discussion ensued on manager risk and how best to mitigate and manage it.

Mr. Paroian said within Plan 3 and the Deferred Compensation Program, the retirement strategy funds had a good quarter. Walden had good performance for the quarter and over the 5-year period. All passive equity and equity-only options were within 10 bps of their benchmark for the quarter, which is in line with staff's expectations.

Real Estate

Mr. Draper said the real estate asset class has the advantage of taking a longer term view. The 10-year portfolio return was 120 bps ahead of its benchmark as of December 31, 2011. He said the economic downturn resulted in a historic deep decline for real estate. While most reports about the downturn relate to residential housing, the commercial space was also hit hard. He said the recovery thus far can mostly be attributed to people putting money into the market versus improved operating conditions. Looking back at what happened over the past 5- and 3-year periods provides a view of what happened within the quarters before the economy fell apart, as well as the recovery. Compared to the NCREIF index, the WSIB was under by 500 bps for the 5-year but ahead in the 3-year period. There were some significant commitments to structured finance investments during the 5-year period, which provide higher yields during good economic conditions but can have a significant downside in a bad economy. Another area hit hard was highly leveraged investments. Those structured finance and highly leveraged investments that survived required significant time from our partners on restructuring, refinancing, and fixing things broken by the downturn versus seeking opportunistic investments in that environment. Mr. Draper said larger, more stable companies, like Corporate Properties of the Americas, did well over the 5-year period as it held industrial property in Mexico, with longer leases than anything else in the portfolio and the income therefore remained stable. He said positions in emerging markets were also beneficial.

For the 3-year period, the investments with negative returns were similar to the five-year period, but the composition of funds affected performance. He noted differences between the Morgan Stanley Real Estate (MSREF) and Special Situations funds. The MSREF Fund is oriented to highly-leveraged property investments, while Special Situations invests in minority interest in operating companies. MSREF lost more than half of its value during the 3-year period, while Special Situations was slightly positive by less than 1 percent. Mr. Draper relayed that distressed real estate, such as those invested in by Lone Star during the bottom of the downturn, did well.

Mr. Draper said the 1-year return trailed the NCREIF by 300 bps, but was 150 bps higher than NCREIF for the quarter ended December 31. He said structure finance is working itself out and much higher returns were realized over the past year. Nearly all of the real estate operating companies performed well: returns for operating companies versus fund investments were 820 bps higher for the 5-year, 520 bps for the 3-year, and in excess of 1,000 bps in the last 12 months.

Mr. Muhlebach asked to what extent the portfolio was hit by a downturn in rents or occupancy. Mr. Draper said the portfolio took a hit on both, but was hurt mostly by capital value having to do with valuations as opposed to operations. Investments are ahead of the overall market in prime cities and locations, in both rent and occupancy. Mr. Muhlebach said it seems the portfolio is positioned well and will recovery nicely and outperform the markets. Mr. Draper said he anticipates more of a steady incline as opposed to a spike.

Private Equity

Mr. Ruggels reported on private equity portfolio performance for the quarter ended December 31. The portfolio is continuing to recover from the effects of the global financial crisis. Performance is good relative to the benchmark, particularly over longer time periods. The private equity portfolio is tracking close to its target allocation of 25 percent, and significant progress has been made toward repositioning to the model portfolio adopted by Board and in executing the 2012 annual plan. He reported that private equity activity has been quiet year-to-date. Drawdowns and distributions have slowed through April, compared to last year, at $405 million and $717 million, respectively. The portfolio is net cash flow positive, which has been the trend over the last few quarters.

Mr. Ruggels reported that financing markets remain generally strong, despite the uncertainty in Europe and its potential impacts. Fundraising continues to be difficult for many firms, causing them to conserve remaining capital and the bar is raised for new investments. He noted Facebook's initial public offering (IPO) occurring later in the day, in which the WSIB has an interest.

Tangible Assets

Ms. Will introduced the first quarterly discussion of the Tangible Assets portfolio. As its new Senior Investment Officer, she has met with all current partners and others under consideration. Tangibles Assets is a small portfolio with four partners in six funds with 28 holdings. She reported that four funds are fully invested with money for follow-on investments; two funds are still open for new investments—one at approximately 20 percent and the other 50 percent invested. Ms. Will said there are a lot of interesting deals, but also a lot of money chasing those deals which results in high pricing. There is a wide variety of things going on within Tangible Assets. Some infrastructure investments are using private equity modeling, while others are evolving from that and holding assets 20 years for income. She said a lot of capital is being raised in Europe and within the U.S. for energy, agriculture, metals, and mining. The Tangible Assets annual plan will be presented at the July Board meeting.

Hamilton Lane

Ms. Blackburn, Hamilton Lane, presented information on current private equity trends, including slower deal activity, the European struggle, and managers going public. She believes 2012 will be slower than last year despite the availability of credit and low rates, with valuations causing hesitancy. She said there is a big downward trend in announced deal activity, down 50 percent

from 2011. Asia has held relatively steady in deployment of capital. Ms. Blackburn described the differences in how the U.S. and Europe are recovering from the recessionary period. Europe is approaching a maturity wall, which could present investment opportunities. Liquidity is expected to slow although the WSIB still has positive cash flow. Ms. Blackburn commented on the IPO market and managers going public. She said managers are hoping for better fundraising this year–-it is currently taking up to two years to raise funds.
Ms. Blackburn reported that returns rebounded in the fourth quarter of 2011. The WSIB portfolio had approximately $879 million in net positive cash flow for the year 2011, and the portfolio generated gains of about $840 million during the year..

Chair McIntire asked if the WSIB is linked to any of the European investments facing the debt wall. Ms. Blackburn said the WSIB has approximately 24.5 percent in underlying asset exposure.

OTHER ITEMS
Chair McIntire announced the Board will defer action on the Adoption of the April 19, 2012, Board minutes; Board Policy Review; and Executive Director Reappointment to the June Board meeting due to lack of quorum.

There were no further items to come before the Board, and the meeting adjourned at 1:40 p.m.

James L. McIntire
Chair

ATTEST

Theresa J. Whitmarsh
Executive Director