WASHINGTON STATE INVESTMENT BOARD
Board Meeting Minutes
February 21, 2013

The Washington State Investment Board met in open session at 9:34 a.m. in the boardroom at 2100 Evergreen Park Drive SW, Olympia, Washington.

Present:	Treasurer Jim McIntire, Chair Mike Ragan, Vice Chair Marcie Frost Bill Longbrake George Masten Patrick McElligott Richard Muhlebach Bob Nakahara Senator Sharon Nelson David Nierenberg Judi Owens Joel Sacks Jeff Seely Natasha Williams
Absent:	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 Allyson Tucker, Senior Investment Officer – Risk Management and Asset Allocation Bill Kennett, Senior Investment Officer – Fixed Income Phil Paroian, Senior Investment Officer – Public Equity Tom Ruggels, Senior Investment Officer – Private Equity Steve Draper, Senior Investment Officer – Real Estate Diana Will, Senior Investment Officer – Tangible Assets Kristi Haines, Executive Assistant Kristi Bromley, Administrative Assistant – Investment Division Steve Dietrich, Attorney General's Office Matt Smith, State Actuary Steve Bowers, Terramar Retail Properties Bill Beckeman, Linear Retail Properties Graham Douglas, Portico Investments Rob Jenner, Centerscape Bob McCrory, EFI Actuaries Neil Rue, Pension Consulting Alliance

[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 THE JANUARY 17, 2013, BOARD MEETING MINUTES

Ms. Owens moved to adopt the January 17, 2013, minutes. Vice Chair Ragan seconded, and the motion carried unanimously.

PUBLIC COMMENT

There was no public comment.

EXECUTIVE DIRECTOR'S REPORT

Ms. Whitmarsh reported that most of the March Committee and Board meetings had been cancelled aside from the Audit Committee, which meets on March 5. She said that she and Ms. Mendizabal have represented the WSIB in 30 meetings this session with Legislators and key legislative staff. The WSIB story has been well received. Ms. Whitmarsh believes the timing is good for the WSIB budget request, which includes compensation and additional staff. Both sides of the aisle have been receptive to the proposal and seem to recognize the challenge in keeping specialized and technical staff.

ADMINISTRATIVE COMMITTEE REPORT

Treasurer McIntire reported the Administrative Committee met earlier this morning. He called upon Ms. Whitmarsh to present the proposed 2013 Strategic Plan.

Strategic Plan

Ms. Whitmarsh said she received feedback on the strategic plan themes from the Administrative Committee in January, and made modifications and adjustments as suggested. She reviewed the strengths, challenges, and opportunities for the WSIB, based on capabilities the agency has developed over the past 5 to 6 years. She described the WSIB framework of value, support, and capacity, which rests upon the foundation of a skillful Board.

Ms. Whitmarsh said that value will be tougher to deliver in the future, and capital market assumptions were lowered based on that view. In every asset class annual plan, staff is challenging themselves with where the source of value creation will come from in the future and how staff can identify those sources. Some market demographics look great at first glance but, once staff get on the ground, investments do not look as appealing. Staff has to reach deeper into markets to achieve desired results. Also, there have been negative changes in alignment of interest with some of WSIB's largest investment partners going public.

In terms of support, WSIB cannot take it for granted. Ms. Whitmarsh said she has become more optimistic after meetings with Legislators, who have shown keen interest in WSIB's performance and seem to understand the 8 percent assumed rate of return that has been met over two decades is really tough to do going forward in this environment. WSIB is dealing with capacity constraints but those cannot stop staff from being innovative. Staff is tweaking WSIB's business model to stay abreast of opportunities in order to get creative on implementing strategy.

Ms. Whitmarsh said the work resulting from the Governance *ad hoc* Committee is helping to mitigate the challenge of recent Board member turnover, by advising appointing authorities and emphasizing members' responsibilities. She feels much better about the continuity of the Board.

She believes the WSIB is well positioned to exploit opportunities as it has spent the past 7 to 8 years developing risk research, analytics, and an infrastructure of tools, staff, and partners to get insights within the global portfolio so staff can more fully understand what has driven past performance and these enhanced capabilities can assist with decision making going forward. While analytics are never a substitute for experience and judgment, they are critical components for even more sound judgments. The analytic capabilities gives the WSIB a significant advantage to identify what risk it is willing to accept that may be different than other funds. Understanding the primary drivers of return will assist staff to do a better job of knowing what trade-off decisions to make with scarce resources. It also helps unite the front, back, and middle office functions, to continue a culture that is focused on performance.

Ms. Whitmarsh detailed the initiatives built in each area of value, support, capacity, and Board governance.
Value initiatives include asset allocation, implementation, and cost effectiveness. She described the resulting projects and examples of each initiative, which includes a full asset allocation review, looking at how staff implements decisions, and macroeconomic considerations. She reviewed tactical goals for the year for each asset class.

Capacity initiatives include performance and cost analyses and reporting, leadership development, and process improvement throughout the agency. She reviewed tactical goals for the middle and back office functions. Support initiatives for Institutional Relations include a focus on communication with stakeholders, Legislators, and the media, as well as being more strategic with the corporate governance program.

Governance initiatives include telling the WSIB story; board independence, continuity, and competence; and Board effectiveness. Tactical projects include assisting with a smooth transition for new trustees, individual Board member development plans, and overhauling the Board's self-evaluation processes.

Mr. Longbrake said two topics emerging from the economics profession about future growth rates include examining demographics trends and the level of investment that translates into productivity and then higher rates of return. He would like staff to examine those as it works on asset allocation.

Mr. Nierenberg suggested that places to add human capacity should be tied to strategic initiatives. Ms. Whitmarsh said staff can approach the Legislature with cost/benefit analyses for adding staff. Chair McIntire said that approach builds appreciation for what the WSIB does and how well it does it, by telling a specific story about a specific strategy that improves the organization. Mr. Nierenberg commented this asserts that WSIB is willing to be an independent thinker and make decisions ahead of the pack.

Vice Chair Ragan moved the Board approve the 2013 strategic plan. Mr. McElligott seconded, and the motion carried unanimously.

Chair McIntire reported the Administrative Committee received the quarterly budget report. The appropriated budget has a projected balance of $930,000 (6.2 percent savings), and the non-appropriated budget has a projected balance of $40 million (11.8 percent savings).

Conflict of Interest Policy Compliance Enforcement
In response to a request from the Chair, Mr. Dietrich provided a memo explaining the Board's authority to enforce policies pertaining to members. He said the authority rests largely with the appointing authority, although the Board could refer issues.

Legislative Update
Chair McIntire relayed information on a house bill introduced relating to having the WSIB manage investments within the Commingled Trust Fund (CTF) for the "first class cities," which are Spokane, Seattle, and Tacoma. He said he prefers the Board not take a position on the issue, but ask the city councils and commissions to seek statutory structure. He said, in his role as Treasurer, he would recommend the bill not include adding another Board member position to the WSIB's structure. He said the legislation will need time to develop. A discussion ensued on how those funds are currently managed, their structure and size, and performance. Ms. Whitmarsh said the legislation calls for the bodies to negotiate with the WSIB to invest their assets. She has had a number of conversations with city staffers and the WSIB submitted a fiscal note to accompany the legislation. She said the WSIB has final say on whether or not to take on the funds, which gives an opportunity to examine all issues. The Board agreed that it would not take a position on the proposed legislation.

PUBLIC MARKETS COMMITTEE REPORT
Manager Recommendation – Defined Contribution Socially Responsible Investment Option
Ms. Owens said the Public Markets Committee met on February 5, to consider the candidate for the socially responsible investment (SRI) mandate within the defined contribution programs. Walden Asset Management has been the investment manager for the SRI option within the defined contribution programs since July 2003. Their contract expires on June 30, 2013. Staff evaluated the universe of SRI managers and worked closely with the Department of Retirement Services during this process. The recommendation to retain Walden is based on their investment performance; engagement with companies on environmental, social, and governance issues; and their fit with WSIB, as well as other relevant factors.

> **Ms. Owens moved the Board retain Walden Asset Management as the defined contribution socially responsible investment manager, subject to continued due diligence and final negotiation of terms and conditions. Mr. McElligott seconded, and the motion carried unanimously.**

[Senator Nelson arrived at 10:36 a.m.]

OATH OF OFFICE
Chair McIntire administered the oath of office to Senator Sharon Nelson, appointed by the Lieutenant Governor as the Senate Board member for a two-year term from January 29, 2013, until December 31, 2014.

Senator Nelson provided information on her background.

[The Board took a recess at 10:38 a.m., and reconvened in open session at 10:55 a.m.]

[Senator Nelson left at 10:50 a.m.]

COMMINGLED TRUST FUND QUARTERLY PERFORMANCE UPDATE

Mr. Bruebaker provided the CTF quarterly update noting the CTF investment performance was up 2.7 percent for the quarter and up 13.7 percent for the year ended December 31, 2012. The since inception return of the CTF was 8.6 percent as of December 31, 2012. The WSIB investment portfolios continue to be positioned well for the long term but will lag in the shorter term when the public markets outperform private markets as they did for the year ended December 31, 2012, when public equities were up 17 percent compared to private equity's rise of 15 percent. The WSIB's long-term investment performance continues to be top decile compared to other public funds between $40 billion and $235 billion in assets under management.

PRIVATE MARKETS COMMITTEE REPORT

Mr. Masten reported the Private Markets Committee met on February 7, to consider two private equity investment recommendations, the tangible assets annual plan, and revisions to the Tangible Assets Investments Policy.

Private Equity Investment Recommendation – KKR North America Fund XI, L.P.

> **Mr. Masten moved the Board invest an additional $250 million, plus fees and expenses, in KKR North America Fund XI, L.P. (NAXI), subject to continuing due diligence and final negotiation of terms and conditions. Mr. McElligott seconded, and the motion carried unanimously.**

In February 2011, the Board approved an investment of $500 million in NAXI, which closed in February 2012. This additional investment would raise the WSIB's total NAXI investment to $750 million. This proposed investment is consistent with the Board-approved 2013 private equity annual plan and model portfolio. The recommendation is based on KKR's strong franchise, deep and experienced investment team, strong and consistent long-term track record, successful value-creation strategy, and fit in the WSIB's private equity portfolio, as well as other relevant factors.

Private Equity Investment Recommendation – Affinity Asia Pacific Fund IV, L.P.

> **Mr. Masten moved the Board invest up to $300 million, plus fees and expenses, in Affinity Asia Pacific Fund IV, L.P., subject to continuing due diligence and final negotiation of terms and conditions. Chair McIntire seconded, and the motion carried unanimously.**

The fund will make control buyout investments in market-leading companies in Korea, Australia, New Zealand, Greater China, and Southeast Asia. The proposed investment is consistent with the Board-approved 2013 private equity annual plan and model portfolio. The recommendation is based on the firm's reputation in the marketplace, experienced and cohesive management team, pan-Asian strategy, strong track record, and fit in the WSIB's private equity portfolio, as well as other relevant factors.

Executive Session – 2013 Tangible Assets Annual Plan
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 executive session was expected to last until approximately 10 minutes, at which time the Board would reconvene in open session.

[The Board convened in executive session at 11:03 a.m., and reconvened in open session at 11:13 a.m.]

> **Mr. Masten moved the Board adopt the confidential 2013 Tangible Assets Annual Plan that was presented and discussed in executive session. Ms. Williams seconded, and the motion carried unanimously.**

Tangible Assets Investments Policy 2.10.900 Revision

> **Mr. Masten moved the Board adopt the proposed revisions to Policy 2.10.900. Chair McIntire seconded, and the motion carried unanimously.**

Mr. Masten noted the policy revisions aligned the policy with the new tangible asset framework and implementation strategy as discussed in the annual plan.

RECOGNITION
Chair McIntire, the Board, and staff thanked Mr. McElligott for his 16 years of service on the Board, presented him with a letter of appreciation, and wished him the best of luck in his future endeavors.

EDUCATION SESSION
Retail Real Estate
Mr. Draper introduced the retail real estate education presentation, which would be provided by the chief executive officers of four of the real estate operating companies within the WSIB real estate portfolio. Mr. Bowers, Terramar Retail Properties, introduced himself and provided an overview of Terramar, which has a portfolio of neighborhood specialty and community centers located in the western U.S. states. He provided information on the dynamics of core market retail within their market areas and provided an overview of three of Terramar's shopping centers, noting the importance of location, demographics, transportation corridors, and merchandise mix. Mr. Beckeman, Linear Retail Properties, introduced himself and provided an overview of Linear, which is focused on convenience retail in New England. He reviewed the market characteristics and property types for their strategy and provided examples of each.

[Mr. Nakahara left at 11:57 a.m.]
[The Board recessed for lunch at 11:57 a.m., and reconvened at 12:20 p.m.]

Mr. Douglas, Portico Investments, introduced himself and provided an overview of Portico's core business of investing in convenience related retail in locations in Poland, Hungary, Romania, and the Czech Republic that are integrated into the urban fabric of the communities. Mr. Douglas noted the importance of demographics and Portico's experience with cross-border transactions. Mr. Jenner, Centerscape, introduced himself and provided an overview of Centerscape, an investor, developer, owner, and manager of grocery-anchored retail properties in Germany. He provided an overview of Centerscape's current portfolio, noted key reasons to invest in Germany, and highlighted characteristics of the German retail market.

Discussion ensued regarding the effects of internet sales, as well as the importance of lease structures, anchor tenants, location, and demographics.

[The Board recessed at 1:32 p.m. and reconvened at 1:44 p.m.]

EDUCATION SESSION
Plan Risk Scenario Analysis
Ms. Tucker introduced herself and noted that today's presentation was in response to a request by the Board at the July 2012 meeting. She introduced Mr. Smith, State Actuary, who prepared the risk model used in the analysis on plan risk scenarios and would be presenting jointly. She also noted that two of the Board's asset allocation consultants, Mr. Rue from Pension Consulting Alliance (PCA) and Mr. McCrory from EFI Actuaries, were in attendance and provided input into the analysis.

Ms. Tucker reviewed the CTF investment beliefs most relevant to the education session. The mission of the fund is to maximize return at a prudent level of risk and that the fund has a long-term time horizon. In regard to asset allocation, a broadly diversified portfolio is preferable to a liability-driven portfolio because it offers higher expected returns while also assuring benefit security over the long term. She also provided an overview of the discussions the Board engaged in during the July 2012 meeting where Mr. Rue and Mr. McCrory presented information characterizing the various retirement plans. Their characterization highlighted the fact that the Public Employees' Retirement System (PERS) Plan 1 and Teachers' Retirement System (TRS) Plan 1 were different than the other retirement plans in the CTF due primarily to their maturity profile, closed status, and underfunding. The conclusions from the analysis conducted by PCA/EFI and the Board's discussion were that de-risking strategies were cost prohibitive. As a follow-up from the July 2012 Board meeting, WSIB collaborated with the Office of the State Actuary (OSA) to determine the amount of risk in PERS1 and TRS1 of trust fund depletion, also known as pay-as-you-go (PAYGO) risk. An important component of the analysis was to look at the trade-offs among funding, benefit enhancement, and investment policy.

Ms. Tucker and Mr. Smith reviewed the plan characteristics of PERS1 and TRS1. PERS1 and TRS1 have been closed to new members for over 30 years and are mature funds with more retirees than active members. Both funds are in net payout mode, with benefit payments larger than employer contributions. Both PERS1/TRS1 receive contributions from the employers of active employees in open plans to cover a portion of the unfunded liability. Despite the more mature profile relative to the open plans, the investment horizon for PERS1/TRS1 remains long term (i.e., 15+ years).

Mr. Smith provided background information relative to pension policy. There are three basic pension plan funding options: PAYGO, where contributions are made as benefits are paid, which is the most expensive option; up-front lump sum, where a single lump sum contribution at inception of program to fund all future payments, which is the most expensive in the short term; and systematic actuarial funding, where contributions are made over time, which is a "middle ground" between PAYGO and up-front lump sum and the approach employed by Washington and most other states. Pension fund management consists of three key variables: funding policy, benefits policy, and investment policy. In Washington, the Legislature determines funding policy (i.e., contribution levels) as well as benefit policy, while the WSIB determines investment policy in accordance with its mission, as established by the Legislature, to maximize returns at a prudent level of risk.

Ms. Tucker noted the goal for the analysis of the plan risk in PERS1/TRS1 was to attempt to isolate each of the components of pension fund management to determine the impact of investment policy decision, which is the pension policy component within the Board's control.

Mr. Smith reviewed the four scenarios identified for analysis: baseline, which assumes past practices for funding and benefit enhancements continue; full funding, which assumes full funding up to assumed contribution rate maximums; no benefit enhancements, which assumes no future benefit enhancements; and current law, which assumes full funding (up to assumed maximums) and no future benefit enhancements. Each of the four scenarios were run through the OSA proprietary risk model with the current WSIB CTF target asset allocation and then modeled again assuming an alternate asset allocation for PERS1/TRS1 resulting in modeling of eight different scenarios. Mr. Smith reviewed key definitions and limitations of the analysis. He reviewed the results of the baseline scenario with current asset allocation, which indicated the maximum chance of PAYGO risk in any given year was 26 percent. The result of the current law scenario with current asset allocation showed a decrease in the maximum chance of PAYGO from 26 percent to 13 percent when full funding and no future benefit enhancements were assumed.

Ms. Tucker noted the rationale for introducing the hypothetical alternate asset allocation for PERS1/TRS1 to the analysis was to attempt to isolate the effect of the investment policy decision on plan risk. The alternate asset allocation reduced expected volatility from 13.8 percent to 8.5 percent and reduced expected long-term return from 7.9 percent to 6.0 percent.

Mr. Smith noted the maximum chance of PAYGO dropped from 13 percent to 9 percent with the alternate asset allocation in the current law scenario. He noted that moving to a more conservative asset allocation would reduce the expected level of investment risk and return for the closed plans. Lowering the expected investment return to 6 percent would result in a 72 percent increase in the unfunded actuarial accrued liability (UAAL) at June 30, 2011. The increase in UAAL would decrease the funded status of the closed plans even further in the short term and result in higher expected contribution rates for employers to cover legacy costs. As a result, the expected budget impact for all employers for the 2013-2015 biennium would be approximately $700 million, which represented a 20 percent increase in expected employer contributions.

Mr. Bruebaker noted the importance of looking at the whole picture. The present value cost of adopting a more conservative asset allocation for those two plans, in order to reduce risk, was $3.7 billion.

Mr. Smith noted the importance of thinking about the potential outcome if the risk is not managed. He presented graphs depicting the funded ratio projections of PERS1 and TRS1 under current law for both the current asset allocation and the alternate asset allocation. Mr. Smith summarized the maximum PAYGO risk and maximum expected benefit payments over the next 5 years, 5 to 10 years, 10 to 15 years, and 15 to 20 year horizons. He concluded by stating the funding and benefits policy are the most impactful decisions when mitigating PAYGO risk but that a change in asset allocation for PERS1/TRS1 could further reduce PAYGO risk, although the risk reduction from investment policy changes might be cost prohibitive.

Discussion ensued regarding the current asset allocation and alternate asset allocation and modeling scenarios. In response to a question from Mr. Sacks, Mr. Bruebaker clarified that if a more conservative asset allocation were adopted for PERS1/TRS1 and employer contributions did not increase, the risk of PAYGO would increase rather than decrease. Further discussion ensued regarding the potential impact of de-commingling the PERS1/TRS1 assets from the CTF on the investment management of the remaining assets in the CTF.

Ms. Tucker reviewed additional considerations including cash flow profile differences among plans and the effects of commingling the assets. She concluded by reiterating that while benefit and funding policy have more of an effect on PAYGO risk than investment policy, investment policy made a difference. However, adopting a more conservative asset allocation for the underfunded plans may be cost prohibitive. She reviewed considerations for the CTF, noting that, barring extreme market events, the baseline analysis shows that plan risk in the closed plans appeared manageable in the next 10 years but climbs significantly in the 10- to 20-year time horizon. Given current investment policy, investment decisions made today affect the next 10 to 15 years due to the large private markets portfolio.

The Board discussed the importance of benefit policy, funding policy, and investment policy on the overall pension system and discussion ensued regarding the realities of the economic and state budget environments.

OTHER ITEMS

There were no further items to come before the Board, and the meeting adjourned at 3:18 p.m.

James L. McIntire
Chair

ATTEST

Theresa J. Whitmarsh
Executive Director