

WASHINGTON STATE INVESTMENT BOARD
Board Meeting Minutes
June 20, 2013

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

Present: Treasurer Jim McIntire, Chair
 Mike Ragan, Vice Chair
 Kelly Fox
 Marcie Frost
 George Masten
 Richard Muhlebach
 Bob Nakahara
 Senator Sharon Nelson
 David Nierenberg
 Joel Sacks
 Jeff Seely

Absent: Bill Longbrake
 Judi Owens
 Representative Sharon Tomiko Santos
 Natasha Williams

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
 Allyson Tucker, Senior Investment Officer – Risk Management
 and Asset Allocation
 Diana Will, Senior Investment Officer – Tangible Assets
 Kristi Haines, Executive Assistant
 Mary Hougan, Administrative Assistant – Operations

 Steve Dietrich, Attorney General's Office
 Scott Daniels, Conning Asset Management
 Michael Humphrey, Courtland Partners

[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 – MAY 16, 2013

Mr. Masten moved to adopt the May 16, 2013, Board meeting minutes. Vice Chair Ragan seconded, and the motion carried unanimously.

PUBLIC COMMENT

Mr. Boris Popovic of Main Street Alliance of Washington and Mr. Mauricio Ayon of Washington Community Action Network addressed the Board with concerns relating to the alleged potential sale of the *Los Angeles Times* by private equity firm Oaktree to Koch Industries Inc.

Six employees of Caesars' Palace and a Local 226 union organizer from Las Vegas, along with a Ms. Alyssa Giachino of UNITE HERE, addressed the Board with concerns relating to the fees charged by private equity firms TPG and Apollo after the takeover of Caesars' Palace. The employees expressed concerns about resulting difficult working conditions and a reduction in service to clients.

Chair McIntire thanked all parties for their testimony. He said the comments relate to private equity investments of the WSIB, and the terms and conditions of the WSIB's contract with these private equity partners prevent the Board from commenting. He noted for the record that the WSIB is not an investor in Apollo.

COMMITTEE ASSIGNMENTS

Chair McIntire moved that the Board appoint Ms. Frost as the Public Markets Committee Chair, replacing Ms. Owens. Vice Chair Ragan seconded, and the motion carried unanimously.

EXECUTIVE DIRECTOR'S REPORT

Ms. Whitmarsh reported that planning for the July Board session is going well. The primary focus of that meeting is strategic asset allocation. Guest speakers in July will discuss the latest trends in venture and lead a corporate governance discussion. Ms. Whitmarsh said both the Public Markets and Private Markets Committee meetings in July are cancelled. She noted the nine contract extensions recommended in the Public Equity annual plan, two of the original Tangible Assets consultants, and one emerging market real estate consultant will be renewed.

Ms. Whitmarsh introduced Ms. Mary Hougan, Administrative Assistant – Operations, who supports Mr. Moore. She announced Mr. Dino Patiag joined the WSIB in the Investment Accounting unit, and Mr. James Sinks was promoted in the Information Systems unit. Recruitment has begun to fill the vacant Data Steward – Information Technology Specialist 4 in that same unit. Mr. Dietrich introduced Ms. Mary Lobdell, his successor as the Assistant Attorney General assigned to represent the WSIB. Ms. Lobdell provided a brief background of her work history and experience. Finally, Ms. Whitmarsh noted that Mr. Bruebaker is quoted in a book entitled *Other People's Money* by Charles V. Bagli, and excerpts are included in the Board materials.

PUBLIC MARKETS COMMITTEE REPORT

Developmental Disabilities Endowment Trust Fund Policy

Mr. Sacks reported the Public Markets Committee met on June 11 to consider revisions to the Developmental Disabilities Endowment Trust Fund Policy 2.35.400, and two investment recommendations that will be discussed during executive session later in the meeting.

Developmental Disabilities Endowment Trust Fund Policy 2.35.400 Policy Revision

The private funds invested in the Developmental Disabilities Endowment Trust Fund (DDEF) are managed by Vanguard. Last fall, Vanguard reviewed the benchmarks for many of their funds, including the balanced fund in which the DDEF private funds are invested. The benchmark for this fund was changed from the MSCI U.S. Broad Market Index to the CRSP U.S. Total Market Index. Accordingly, the DDEF Policy 2.35.400 must be revised to reflect the change in benchmark.

Mr. Sacks moved that the Board approve the proposed revisions to the Developmental Disabilities Endowment Trust Fund Policy 2.35.400. Vice Chair Ragan seconded, and the motion carried unanimously.

Public Equity Emerging Markets Program – Passive Emerging Markets

Mr. Sacks noted the Committee also heard a presentation from staff on the addition of a passive emerging markets fund within the Commingled Trust Fund (CTF). The CTF currently employs passive equity portfolios for U.S. and non-U.S. equities. The addition of a passive emerging markets portfolio will provide a low cost way for the public equity program to maintain the appropriate allocation to emerging markets. Staff will utilize one of the WSIB's current passive equity managers, BlackRock or State Street Global Advisors, for the portfolio. The current contracts with each manager allow for the addition of this portfolio.

ADMINISTRATIVE COMMITTEE REPORT

Board Self-Evaluation Process

Chair McIntire reported the Administrative Committee met earlier to discuss the assessment tool for the Board's self-evaluation discussion at the July meeting. One question was added to address what members feel they need to improve their level of comfort with the Board.

Chair McIntire moved that the Board use the proposed evaluation tool for conducting its self-evaluation at the July Board meeting. Vice Chair Ragan seconded, and the motion carried unanimously.

Chair McIntire asked for Board members to respond to the self-evaluation assessment prior to the July meeting, and to find time to speak with the him beforehand.

Chair McIntire reported the WSIB appropriated budget has a projected balance of \$1 million (7.2 percent savings), and the non-appropriated budget has a projected balance of \$32 million (9.5 percent savings). Savings are the result of not filling some positions as promptly as expected. He said the Committee also discussed continuity

planning in the event the Legislature failed to adopt a budget by the end of the fiscal year. The WSIB plans to remain open and has received acknowledgment from the Office of Financial Management that it has the authority to do so. He described an informal legal opinion provided by the Attorney General's Office to the Office of the State Treasurer, which stated that some agencies, such as the WSIB, not only may remain open, but should remain open to assure that beneficiaries of the invested trust funds will continue to receive the benefits they are legally entitled to receive.

LABOR & INDUSTRIES' PORTFOLIO UPDATE

Mr. Daniels provided a brief overview of Conning. He said Labor and Industries (L&I) is a \$14 billion portfolio. Mr. Nierenberg noted the percentage of bonds in the various portfolios and questioned whether that provides a margin of safety against inflation. He asked if alternative asset allocations could be considered. Mr. Daniels said the portfolio allocation balances between protecting the capital base and inflation. The portfolio already has a significant exposure to stocks and Treasury Inflation Protection Securities (TIPS) and increasing that would put solvency at risk. A discussion ensued relating to premium rate stability and adjustments, statutory reporting required for workers compensation, the effect of bonds being marked to market, and maintaining a portfolio balance higher than liabilities. Mr. Sacks said the longer-term target is to achieve a 14 percent cushion.

Mr. Daniels said the portfolio has some unique characteristics, with rate stability as its primary objective. Other objectives are to maintain solvency, ensure there are sufficient assets to fund liabilities, and earn a maximum return at prudent level of risk subject to the other objectives. He said stakeholders' objectives vary. L&I is the third largest state fund, with liabilities that are longer than most workers' compensation insurances. He said the portfolio is tax exempt and, despite having to follow statutory accounting, the Department of Insurance does not regulate it. Mr. Daniels reviewed the financial statement as of June 30, 2012. He discussed the implications for the investment strategy to balance the objectives, and reviewed the current strategic asset allocation targets for the accident, medical aid, and pension reserve funds. He discussed L&I's contingency reserve, interest rate, reinvestment, and inflation risks. He said that income is the primary goal for the portfolio. He reviewed the make-up of the portfolio including cash, fixed income, TIPS, and equities.

He compared L&I's overall asset allocation to peers. It has a larger allocation to BBB bonds than other state funds, and more common stock than other peers. He said the portfolio has much more equities than most insurers, and the bond exposure stands out compared to comparable peers, as L&I has a longer portfolio on average. Mr. Daniels discussed L&I's performance compared to comparable market indices (CMI's). He said CMI's only measure total returns but provide a picture of how much risk is taken in the portfolio. He noted the portfolio's long-term performance is reasonable and is outperforming the CMI's for most periods. It is a moderate risk portfolio. Mr. Sacks thanked the WSIB and Conning for the ongoing relationship with L&I. He said Conning's peer analysis is important to set benchmarks on both the investment and operations side, and so L&I understands what is happening in the rest of the country.

In response to Mr. Seely's remarks about the adequacy of contingency reserve at the end of this fiscal year, Mr. Daniels said positive equity market performance will provide a slight increase in the reserve. Mr. Sacks said there was \$693 million in the contingency

reserve as of yesterday. He said L&I would like to have a balance of \$1.4 billion. Mr. Daniels said the balance of a sufficient margin of safety against premium rate levels is L&I's biggest challenge. A discussion ensued about the effect that statutory accounting has on the contingency reserve. Chair McIntire noted the peer comparison is challenging as Washington's portfolio is fairly different, and it is difficult for policy makers to understand and set a management structure without looking at comparable programs.

EXECUTIVE SESSION

Chair McIntire announced the Board would go into executive session to discuss financial and commercial information relating to an investment, to discuss litigation or potential litigation, and to enable a discussion with legal counsel. Public knowledge regarding these discussions would result in loss to the funds managed by the WSIB or would result in private loss to the providers of the information, and is likely to result in an adverse legal or financial consequence. He said the executive session was expected to last until about 11:00 a.m., at which time the Board will reconvene in open session.

[The Board went into executive session at 10:48 a.m.]

Public Markets Committee Report

Investment Recommendations

Audit Committee Report

Potential Litigation

Quarterly Commingled Trust Fund Board Risk Report

The report was included in the Board materials.

[The Board reconvened in open session at 11:28 a.m.]

Public Equity Emerging Markets Investment Recommendation

Mr. Sacks moved that the Board take the specific action discussed in executive session regarding the public equity emerging markets program. Mr. Masten seconded, and the motion carried unanimously.

Defined Contribution Retirement Strategy Funds Investment Recommendations

Mr. Sacks moved that the Board take the specific action discussed in executive session regarding the defined contribution retirement strategy funds program. Ms. Frost seconded, and the motion carried unanimously.

AUDIT COMMITTEE REPORT

Fiscal Year 2014 Annual Internal Audit Plan

Mr. Masten reported the Audit Committee met on June 11 to review internal audit reports on Shott Capital and Computer Assisted Audit Techniques. Neither report contained any recommendations. He said the Committee also received updates on the status of prior audit recommendations, the 2013 Internal Audit Plan, and investment referrals.

The Committee received an update on the WSIB's efforts to engage companies that have been identified as doing business in Sudan. The Committee directed staff to send a follow-up letter to the companies that did not respond to the previous letter.

The Committee reviewed the independence of the Board's financial statement auditor, Peterson Sullivan, along with audit results for the calendar year 2012 Conflict of Interest Policy Compliance Review, conducted by Peterson Sullivan. Staff was directed to perform an interim follow-up review of the travel costs paid for directly by outside partners and bring the results to the September Audit Committee, to ensure improvements made by management have addressed the exceptions noted in the report.

The Committee also reviewed the fiscal year 2014 Annual Internal Audit Plan.

Mr. Masten moved that the Board adopt the Fiscal Year 2014 Internal Audit Plan. Vice Chair Ragan seconded, and the motion carried unanimously.

[The Board recessed at 11:34 a.m.]

[Mr. Seely left at 11:35 a.m.]

[Mr. Nierenberg left at 11:42 a.m.]

[Senator Nelson left at 11:47 a.m.]

[The Board reconvened in open session at 11:49 a.m.]

REAL ESTATE MARKET UPDATE

Mr. Humphrey, Courtland Partners, said the current catch word for real estate markets is "volatility" as there are high levels of activity occurring in all markets on a global basis. He said the deleveraging in single family housing and commercial real estate continues from the 2008 market downturn. Reflating asset values will help consumer confidence and record low interest rates have helped real estate in general. There is some concern the market has recovered to a point that it no longer needs federal buying program. Now, the significant issue for real estate is, if interest rates go up, capitalization rates will go up. He said that London, New York City, and Tokyo are "safe haven" markets. On a global basis, larger pension funds—particularly in Europe—do not have good global diversification but are moving toward that now.

Mr. Humphrey said the impact of policy changes on emerging markets is also interesting. For gross domestic product growth (GDP) since 2008, the North America recovery has been ahead of Europe, but lagged Asia. Courtland believes this trend is likely to continue. Europe continues to struggle as it has issues surrounding debt, as does the U.S., but is not as far along dealing with it. Mr. Humphrey discussed a forecast for China's growth in comparison to Europe and the U.S. He said China investment opportunities compared to India are more interesting. He noted that WSIB staff has focused on attempting to find appropriate investments in India, but it has been challenging thus far.

Mr. Humphrey highlighted the affect interest rates have had on yield spreads. Some pension funds are looking to shift fixed income into real estate. He reviewed the increase in real estate volume sales since 2007. Europe is struggling and that is likely to

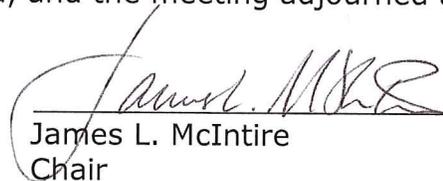
continue. Issues with the Euro may take some time to work out. He reviewed the global growth outlook, which is underperforming based on GDP growth. He commented on the most active global markets in real estate during 2012. He noted that Seattle has been very active for a secondary market. He reviewed projected growth in direct commercial real estate investments. Secondary markets are attracting more capital than primary markets in 2013.

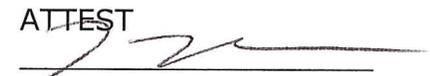
Mr. Humphrey reviewed the U.S. single family housing market; cap rates, vacancy, capital flows and yields; spreads over the 10-year Treasury and total returns; property price changes; recovery by property type; distressed debt; de-leveraging; and transaction volumes. He concluded his report by stating the materials presented are compiled on a quarterly basis and he is happy to present to the Board at any time.

Chair McIntire noted the hot market in Seattle and favorable economic forecast. He asked Mr. Humphrey what the timeframe is for the correction in the market that he noted earlier in his presentation. Mr. Humphrey said it took about 5 years to recover in the 1990s and noted the difference from then and now and believes it will take another 2 to 3 years, depending on Federal Reserve policy changes. Mr. Muhlebach asked, as a long-term investor, WSIB will likely acquire more properties than sell, and shouldn't that be an advantage to WSIB? Mr. Muhlebach also noted the WSIB's real estate portfolio is based more on necessity, versus location. Mr. Humphrey said he believes the strategy will be successful, and discussed co-investment and property type opportunities in various markets.

OTHER ITEMS

There were no further items to come before the Board, and the meeting adjourned at 12:28 p.m.


James L. McIntire
Chair

ATTEST

Theresa J. Whitmarsh
Executive Director