WASHINGTON STATE INVESTMENT BOARD
Board Meeting Minutes
January 16, 2014

The Washington State Investment Board met in open session at 9:42 a.m. in the boardroom at 2100 Evergreen Park Drive SW, Olympia, Washington.

Present:
Treasurer Jim McIntire, Chair
Marcie Frost, Vice Chair
Kelly Fox
Arlista Holman
Bill Longbrake
George Masten
Stephen Miller
Richard Muhlebach
Bob Nakahara
Joel Sacks
Jeff Seely (teleconferenced)

Absent:
Senator Sharon Nelson
David Nierenberg
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
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 – Tangibles
Janet Kruzel, Assistant Senior Investment Officer – Private Equity
Kristi Haines, Executive Assistant
Kristi Bromley, Administrative Assistant - Investments

Mary Lobdell, Attorney General's Office
Scott Daniels, Conning Asset Management

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

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

OATH OF OFFICE
Chair McIntire gave the oath of office to Mr. Stephen Miller, newly appointed Board member, who fills the unexpired term of the Teachers' Retirement System member position through 2013, and then continues for a 3-year term expiring December 31, 2016. Mr. Miller provided an overview of his background and experience.

ADOPTION OF THE DECEMBER 19, 2013, MEETING MINUTES

> **Mr. Sacks moved to adopt the December 19, 2013, meeting minutes. Ms. Holman seconded, and the motion carried unanimously.**

PUBLIC COMMENT
There was no public comment.

COMMITTEE ASSIGNMENTS

> **Chair McIntire moved that the Board approve his recommendation to assign Mr. Stephen Miller to the Public Markets Committee meeting. Ms. Frost seconded, and the motion carried unanimously.**

Chair McIntire said he is trying to balance the Committees and members are welcome to contact him with any comment about assignments.

EXECUTIVE DIRECTOR'S REPORT
Ms. Whitmarsh said the Private Markets Committee meets February 6, but the Public Markets Committee is cancelled in February. She introduced Susan Freese, new Investment Officer – Tangible Assets, and provided information on her background and experience. Ms. Whitmarsh said the Washington State Opportunity Scholarship fund's proposed legislation has been drafted and finalized for legislative consideration.
Chair McIntire asked staff to coordinate with his office on communications relating to that legislation.

PUBLIC MARKETS COMMITTEE REPORT
Mr. Fox reported the Public Markets Committee met on January 7 to participate in an education session on stable value funds and consider a revision to the Savings Pool Investment Policy. The Committee also considered an investment recommendation regarding alternative passive and the associated policy revision and participated in the Public Equity 2014 Annual Planning session.

Savings Pool Investment Policy 2.13.200 Revision
Mr. Fox said the Savings Pool is a stable value fund with the primary investment objectives of ensuring safety of principal and providing adequate liquidity to meet any withdrawal requests. The Savings Pool is comprised of guaranteed investment contracts issued by insurance companies and cash in the form of money market funds. The current Savings Pool Policy requires participating insurance companies to have an Insurance Financial Strength rating of Aa3 or better by Moody's. Given the downgrades of insurance company credit ratings over the last few years, particularly since the financial crisis, the number of insurance companies with such a rating has decreased. The proposed policy revision to lower the rating one notch to A1 would increase the number of eligible insurance companies. Moody's definition for Aa3 are those obligations judged to be of high quality and subject to very low credit risk and the definition for A1 are those obligations considered upper-medium grade and subject to low credit risk.

Mr. Fox moved that the Board approve the proposed revisions to the Savings Pool Investment Policy 2.13.200. Ms. Holman seconded, and the motion carried unanimously.

Alternative Passive Investing and Public Markets Equity – Retirement Fund Policy 2.10.100 Revision

Mr. Fox reported that, in September 2013, staff presented a recommendation regarding alternative passive investing to the Public Markets Committee. Subsequent to staff's presentation, a data error was discovered. Staff has since reviewed all the data and analyses, corrected the error, and concluded there was no change to the recommendation to replace a portion of the U.S. passive equity portfolio within the Commingled Trust Fund (CTF) with a passive product managed against a benchmark with a construction methodology that sizes its constituents based on fundamental variables and that emphasizes value characteristics. At the January Committee meeting, staff reviewed the pros and cons of fundamental/value-weighted indices, as well as the rationale for recommending the specific index for implementing this strategy within the CTF.

Mr. Fox moved that the Board replace $1.5 billion of the U.S. passive equity portfolio currently managed against the MSCI U.S. IMI index with a portfolio passively managed against the Russell Fundamental U.S. All Company Index and approve the proposed revisions to the Public Markets Equity – Retirement Fund Policy 2.10.100 to allow for this change. Vice Chair Frost seconded the motion.

Mr. Masten asked for what the one-time cost would be to implement the recommendation, and ongoing annual cost going forward in dollars. Mr. Paroian said historically, these strategies have added 200 basis points (bps) over the longer period of time. Staff said going forward the transaction costs, licensing fees, and management fees are estimated to be 10-15 bps annually of the assets under management in the strategy. Based on an initial funding of $1.5 billion, estimated costs in the first year including transaction costs to convert from market-cap-weighted to fundamental-weighted are estimated to be approximately $2.25 million (15 bps). On an on-going basis, estimated costs (including ongoing rebalancing transaction costs, management fees, and licensing fees) should be approximately $1.5 to $1.8 million (10-12 bps). Mr. Masten asked how that compares to what WSIB pays for index fund now. Mr. Paroian said it is additional. On the U.S. index, the fee is considered proprietary and the WSIB is paying a very minimal amount, so virtually all fees would be an increase over what is currently paid on market cap-weighted indices. Mr. Masten asked if staff has a projection as to when the WSIB would earn sufficient value added to recoup the transition costs and fees. Based on historical value added, Mr. Bruebaker said it would be one month to recover the cost of transition costs, and recoup the annual cost of that's years' running it after an additional 12 days if it performs as projected. He said the costs are guaranteed. Mr. Paroian noted that value added can be episodic and said the biggest benefit would be if there are market pull-backs—staff would expect it to perform well on the downside. He also commented on past performance during periods of upside performance.

The above carried unanimously.

Public Equity Annual Plan

Mr. Paroian said the Public Markets Committee reviewed the Public Equity Annual Plan on January 7, and noted he would present highlights from that discussion.

He said one of the biggest differences between private equity and public equity assets is that private equity is one program; whereas, public equity (and fixed income) oversees a number of separate funds, mandates, managers, and accounts. Focus is an advantage given the number of programs.

Mr. Paroian reviewed Public Equity's 2013 accomplishments within manager monitoring, program enhancement, renewed contracts, an alternative passive recommendation, the emerging markets managers search, research projects, staffing changes, data warehouse and risk system, and participation on ERM and other agency-wide projects and initiatives.

He said public equity is the most liquid of the asset classes; whereas, private markets are illiquid and credit markets during crisis can become difficult for liquidity. For public equity, programs are set-up to always be liquid and strategies with lock-ups are not considered.

Mr. Paroian said there are three types of mandates in the CTF: passive, active global, and active emerging markets. He noted that passive requires more effort than commonly acknowledged and has been a focus of research (e.g., the previous alternative passive recommendation). The active global program put into place in 2011 shows encouraging results. Active emerging markets managers should become more important in the long-term so a search for new managers was initiated in November.

Mr. Paroian noted the difference in asset mixes between defined benefit (DB) and defined contribution (DC) plans, the effect mixes can have on returns, and options available for DC participants. Target Date funds are an important focus going forward. Mr. Paroian said staff is examining participants' desire for return versus liquidity, and will research various potential enhancements. He added that DC plans' default options make a big difference.

[Mr. Nakahara arrived at 10:17 a.m.]

Mr. Paroian discussed the differences in client needs in the Public Equity program for the Labor and Industries (L&I), Guaranteed Education Tuition, Developmental Disabilities Endowment Fund, and Permanent Fund accounts, which are passively managed. He said the passive contracts would be rebid this year to ensure the WSIB is with the best managers and gets the best breadth and depth of skills.

In terms of 2014 initiatives, Mr. Paroian broke down Public Equity's planned work within four themes: monitoring and risk management, enhancements to existing programs, rebids or renewals, and research and potential new initiatives. He said potential new research initiatives are not a key focus for 2014, but he plans to prioritize those as part of next year's annual plan. He also noted other unit considerations, including handling *ad hoc* requests, staff development, agency-wide projects, making time for intellectual capital, and ensuring staff keep fresh by taking time off work. The key initiatives for 2014 are manager monitoring and risk management, the emerging markets search, the passive management rebid, and improving the DC and retirement funds' strategic mix.

In response to Mr. Masten's question, Mr. Paroian said the money to be invested in the alternative passive mandate approved in the previous item is coming from the existing U.S. passive, which is approximately $10 billion and managed by BlackRock. Staff is discussing implementation and bids are going out to BlackRock and State Street to ensure advantageous fee quotes. Other players may be considered in the rebid. He said the cost for the move is estimated to be approximately 15 bps.

In response to Mr. Longbrake's question about staff resource needs, Mr. Paroian said, while increased staff resources would allow public equity to take on a greater number of initiatives, staff had reviewed and prioritized all suggestions, weighed their pros and cons, and boiled them down to what he presented. He pointed out that adding staff also requires time for mentoring and orientation to the WSIB. He believes in hiring modestly, with the right people at the right rate.

Mr. Fox moved that the Board adopt the 2014 Public Equity Annual Plan. Vice Chair Frost seconded, and the motion carried unanimously.

ADMINISTRATIVE COMMITTEE REPORT
Chair McIntire reported the Administrative Committee met earlier this morning. He said Ms. Whitmarsh reviewed the status of the 2013 strategic plan initiatives. She noted many of the plans will take several years to complete, so there are a limited number of new projects for 2014. The Committee's feedback on the proposed 2014 Strategic Plan will be incorporated and presented to the full Board in February.

Assistant Attorney General's Report
Ms. Lobdell reported on the Supreme Court's decision to hear the Halliburton versus Archdiocese of Milwaukie class action case. The Attorney General's Office (AGO) is watching the case closely to determine if the WSIB should sign onto an amicus brief. Halliburton is challenging the presumption of reliance allowed in class action securities cases. Reliance is one of at least three elements required to bring a securities case. If Halliburton successfully overturns the presumption, a lot of securities claims may go away and there would be fewer recoveries for the WSIB. The AGO is looking at briefs to ensure they represent public policy issues that come before the Board.

FIXED INCOME REVIEW AND OUTLOOK
Mr. Kennett presented the 2013 overview of the fixed income program and his outlook for 2014. He said 2013 was a difficult year for fixed income due to rising interest rates. He said many countries need to implement structural reform. He believes quantitative easing will be scaled back after its third round in the U.S. Central bankers have promoted growth with rates close to zero for the fifth year in a row. He noted it should be very interesting when the quantitative easing gets unwound. He reported on negative growth in the Euro area with some countries showing signs of a turnaround. He said the

U.K. economy is improving and some observers are optimistic about Japan—although he is not. Mr. Kennett commented on Japan's monetary and fiscal policies, and structural reform efforts.

Mr. Kennett said he expects the U.S. economy will be a bright spot in 2014, with anticipated growth of 2-3 percent. He believes European and Japanese economies will continue to lag the U.S. He expects developed world inflation to trail central bank targets. Mr. Kennett believes shale gas and oil will add to the U.S.'s output, investment, and employment. Housing will remain strong, but with higher interest rates and home prices. Larger U.S. concerns are the decline in productivity growth, tighter banking regulations, low inflation, and unemployment that is still too high (although declining).

Mr. Kennett said he is still a fan of emerging markets, although they appear to be transitioning to a lower, more sustainable growth rate. He discussed expected growth rates for China, India, Latin America, and Asia ex-Japan. He said growth can be stimulated through monetary and fiscal policies, as emerging markets have lower debt and deficits compared to developed world. Mr. Kennett noted the number of countries with high inflation, and his anticipation of interest rate hikes. He said the reliance on foreign capital for investment is affecting GDP growth. There are low expectations for emerging markets in 2014.

Mr. Kennett discussed economic, social, and political risks anticipated in 2014, as well as the potential credit rating downgrades of Brazil, India, Indonesia, and South Africa. He reviewed the global GDP forecast based on purchasing power parities and market exchange rates and noted that emerging markets are transitioning to slower, more sustainable growth. Developed markets have much higher debt and worse fiscal balances than emerging markets.

Mr. Kennett reviewed the implications of the 2014 outlook for the portfolios, noting caution on credit, in general, and emerging markets, in particular. Relative to developed markets, emerging markets fundamentals are still favorable but uncertainties have risen. Emerging markets still offer higher yields and potentially higher returns than other fixed income asset sectors; the key is to be selective. The portfolios will underweight mortgages because extension risk is not reflected in the prices. Portfolio durations will remain short relative to their respective benchmarks or comparable market indices at least until rates head higher. He noted staff's belief that the 10-year Treasury yield will settle in around 3.5 percent in the medium term and could overshoot in the short term.

He reviewed slides depicting the 10-year Treasury yield, the 10-year to 30-year Treasury bond yield spread, and investment grade credit spreads from December 1989 to December 2013, in addition to the change in the yield curve from December 31, 2012, to December 31, 2013. He also reviewed the Treasury returns for 2013 and the returns of the Barclays Aggregate and Universal indices as of December 31, 2013.

Mr. Kennett reviewed the market values and sector allocations of the fixed income portfolios as of December 31, 2013. With just under $32 billion in assets under management, the largest allocations are to credit and Treasuries. He reviewed the performance, goals, summary statistics, country and industry allocations, and amount of non-U.S. dollar and credit holdings of the retirement fixed income portfolio as of December 31, 2013. He reviewed the goals and implications for portfolio management as well as performance of the L&I, Permanent Funds, Intermediate Bond Fund, Savings Pool, Guaranteed Education Tuition, and Developmental Disabilities Endowment Fund portfolios. Mr. Kennett also reviewed the decision-making framework for the fixed income portfolios, which focuses on macro-economics, market and industry fundamentals, company analysis, security valuations, and judgment. He concluded his presentation by thanking the members of the fixed income team.

[The Board recessed at 11:46 a.m., and reconvened in executive session at 12:24 p.m.]

EXECUTIVE SESSION
2014 Private Equity Annual Plan
Mr. Masten reported the Private Markets Committee met on January 9 to participate in the 2014 Private Equity Annual Planning Session. He said Mr. Ruggels would provide an overview of the plan in executive session.

Chair McIntire announced the Board would go into executive session to 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 12:55 p.m., at which time the Board would reconvene in open session.

[The Board reconvened in open session at 1:17 p.m.]

> **Mr. Masten moved that the Board adopt the confidential 2014 Private Equity Annual Plan that was discussed in executive session. Vice Chair Frost seconded, and the motion carried unanimously.**

LABOR AND INDUSTRIES' STRATEGIC ASSET ALLOCATION STUDY AND INSURANCE FUND POLICY 2.20.100 REVISION
Mr. Kennett introduced Mr. Daniels, Conning Asset Management, and noted that Conning has been providing consulting services to L&I and the WSIB on the L&I portfolio for over 20 years, conducting a number of asset allocation studies and special projects within that time period. Conning meets with L&I staff quarterly.

Mr. Daniels noted that Conning conducted an asset allocation review of the L&I portfolio in 2013. L&I is a very large insurer, the third largest state workers' compensation fund in the U.S. and the seventh largest U.S. workers' compensation insurer. L&I is similar to other insurers in that future benefits are subject to external influences, including inflation as well as judicial and legislative actions. As an insurance entity, L&I uses insurance accounting, which means asset classes are valued in different ways and all investment income is recognized while only some capital gains and losses are recognized. In addition, insurance accounting strongly favors investment grade bonds. L&I also has some unique characteristics that influence investment strategy. They have longer liabilities than most workers' compensation insurers, which results in long duration fixed income portfolios and significant reserve risks. L&I is also exempt from income tax, so no investments are made in municipal bonds. In addition, L&I has multiple stakeholders with conflicting views on capital and risk.

Mr. Daniels reviewed the asset groups utilized within the L&I portfolios: investment grade bonds, Treasury Inflation-Protected Securities (TIPS), below investment grade bonds, and stocks. He noted that the major investment drivers of the level and volatility of premiums and capital are: fixed income duration, stock allocation, TIPS holdings, and below investment grade bond holdings. He reviewed L&I's investment objectives, with the primary goal being to limit premium rate volatility.

Mr. Daniels reviewed L&I's current investment strategy, which was implemented in 2008 and consists of three funds with two different strategies. The Accident Fund and Pension Reserve Fund have longer liabilities and more volatile insurance results. The Medical Aid Fund is exposed to medical inflation and workers pay a portion of the premium. The Accident Fund and Pension Reserve Fund have an 80 percent allocation to bonds, 10 percent allocation to TIPS, and a 10 percent allocation to stocks. The Medical Aid Fund has a 65 percent allocation to bonds, 20 percent allocation to TIPS, and 15 percent allocation to stocks. Mr. Daniels noted that the 2013 investment strategy recommendations for the L&I portfolios were developed jointly by Conning, L&I, and WSIB based on L&I's objectives and risk appetite and involved financial modeling of alternative investment strategies, as well as peer analysis of state funds and private insurers. The current strategies are efficient and all three portfolios are close to their respective efficient frontiers. Changes since 2008 include lower market interest rates, greater emphasis on investment income, and creation of the Rainy Day Fund.
Mr. Daniels reviewed information on the durations of the three portfolios and stated Conning's recommendation of maintaining the duration targets. He also reviewed the portfolios' allocation to stocks and stated Conning's recommendation of maintaining the allocations and ranges. Mr. Daniels reviewed the portfolios' current allocations to TIPS and stated that Conning recommended eliminating the strategic allocation to TIPS. Rather than a separate allocation, TIPS could be purchased as part of the current government allocation. Mr. Daniels recommended that the allocation to credit bonds be increased from a range of 20-70 percent to a range of 20-80 percent.

Mr. Sacks noted that L&I was fully supportive of Conning's recommendations. He stated the WSIB has a rich and successful history in fixed income investing and these recommendations give a little more flexibility to WSIB staff to continue investing in fixed income, which have performed well for the L&I portfolios.

Mr. Kennett noted that staff proposed policy revisions to reflect Conning's recommended changes to the L&I funds' strategic asset allocation.

> **Mr. Sacks moved that the Board approve the recommended changes to the Labor and Industries' funds' strategic asset allocation and revise the Labor and Industries' Insurance Funds Policy 2.20.100 to reflect those changes. Mr. Masten seconded, and the motion carried unanimously.**

ECONOMICALLY TARGET INVESTMENTS ANNUAL REPORT
Ms. Kruzel introduced herself and noted that this was the eleventh annual Economically Targeted Investment (ETI) report. The primary objective of the Board's policy is to produce investment return to pension fund assets with the possibility of collateral benefits. Policy implementation remains focused on relations and collaboration, working

with local, state, and regional organizations to maintain good relationships and serve as a resource.

[Chair McIntire left the meeting at 1:43 p.m., and Vice Chair Frost assumed the role of Acting Chair.]

Ms. Kruzel reviewed the dollars invested and number of deals done in Washington, the Northwest, and the U.S. from July 1, 2012, through June 30, 2013. At the national level, over $26 billion was invested in more than 3,800 deals, which is about $2 billion less than last year but in 100 more deals, indicating smaller deal size. Nearly $900 million was invested in 156 Northwest deals and $707 million in 120 deals was invested in Washington, representing a little better than 75 percent of the deals done and 80 percent of the dollars invested. She reviewed a chart depicting the dollars invested in the U.S., in Washington, and by the WSIB in Washington for the years 2003 to 2012, as well as a chart showing the number of Washington deals done by year in total and by the WSIB for the years 2005 to 2012. Ms. Kruzel also presented a chart that looked at the largest Puget Sound venture capital and private equity firms in 2012 ranked by assets under management. In 2012, the 19 firms had $13.3 billion in assets under management and invested $810 million in total, $230 million of which went into 115 Washington deals and $580 million went into 151 deals outside the state. There is capital at play in the local environment.

Ms. Kruzel noted that the annual poll of WSIB general partners (GPs) shows strong and consistent activity over time. Information is requested from all WSIB GPs that are in the investment period and actively investing in the U.S. This year, 48 partners fit that description, of which 31 looked at 1,515 deals. Ten WSIB GPs invested in 22 Washington-based deals in 2013. None of the 10 was Washington-based investors; rather, all were outside the state. Over all 11 years of reporting, WSIB GPs have consistently reviewed and done deals in Washington.

Ms. Kruzel reviewed the Washington-based investments in the WSIB CTF portfolio by asset class for the past six fiscal years ended June 30. For each of those years, over $1 billion of the WSIB portfolio was invested in Washington. The Washington-based investments represented 1.97 percent of the CTF, an impressive percentage considering the state of Washington's GDP as a percentage of the GDP of the investable universe is only 0.50 percent.

Ms. Kruzel reviewed private equity investments in Washington as of June 30, 2013, noting that there was $185.5 million in market value in Washington-based companies within 40 different funds invested with 28 individual GPs. The investments were diversified among 9 industries. Ms. Kruzel provided an example of a Washington-based company investment round where $165.0 million was invested by three GPs, one of which was a WSIB GP. The WSIB GP invested $103.0 million, or 62.4 percent. The WSIB's portion of that investment was $6.4 million or 6.3 percent of our partner's funding and about 3.9 percent of the total amount that went to the company. The WSIB GP invested $96.6 million from other limited partners in the deal alongside the WSIB contribution.

Discussion ensued regarding the public equity Washington-based investments in 2007 and 2008. Mr. Seely noted that the public equity investments were largely indexedbased investments. Ms. Kruzel confirmed that Washington-based investments across all asset classes are reviewed to determine the full investment exposure to the state of Washington. Mr. Bruebaker noted the WSIB's GPs make the investment decisions in our private equity portfolio so these investments are also passive.

BOARD EDUCATION

Board Effectiveness Program

Mr. Fox provided an overview of the Rotman-ICPM Board Effectiveness Program that he, Vice Chair Frost, and Mr. Sacks attended in December 2013. He noted the program is designed for pension and other long-horizon investment institutions that play important roles in providing economic security for their beneficiaries. The training is designed to support Boards in clarifying their rule in addressing the key strategic issues that have emerged such as fiduciary duties, board dynamics, roles of boards versus management, investment beliefs, risk management, and organization design and human resource management. The members who attended strongly recommended that other Board members take advantage of this educational opportunity.

OTHER ITEMS

Mr. Nakahara noted the increasing frequency of cyber-attacks and the number of individuals affected by the attacks. Ms. Whitmarsh noted that the WSIB has a strong focus on network security.

There was no further business to come before the Board, and the meeting adjourned at 2:17 p.m.

Jim McIntire
Board Chair

ATTEST

Theresa J. Whitmarsh
Executive Director