WASHINGTON STATE INVESTMENT BOARD
Board Meeting Minutes
February 19, 2015

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

Present:	Marcie Frost, Chair Kelly Fox, Vice Chair Senator Mike Hewitt Arlista Holman Judy Kuschel Bill Longbrake (teleconferenced) George Masten Treasurer Jim McIntire Stephen Miller Richard Muhlebach Bob Nakahara David Nierenberg Joel Sacks Jeff Seely
Absent:	Representative Timm Ormsby
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, Confidential Secretary Mary Lobdell, Attorney General's Office

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

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

ADOPTION OF THE JANUARY 15, 2015, MINUTES

Vice Chair Fox moved to adopt the January 15, 2015, minutes. Ms. Kuschel seconded, and the motion carried unanimously.

PUBLIC COMMENT

There was no public comment.

[Mr. Longbrake joined via teleconference at 9:38 a.m.]

COMMITTEE ASSIGNMENTS

Chair Frost suggested a few changes to Committee assignments. She recommended assigning Senator Hewitt to the Private Markets Committee, and removing her from the Private Markets Committee and instead assigning her to the Audit Committee.

> **Treasurer McIntire moved that the Board accept the Chair's recommendations for Committee assignments. Mr. Miller seconded, and the motion carried unanimously.**

EXECUTIVE DIRECTOR'S REPORT

Ms. Whitmarsh reported the Audit Committee would meet on March 3, but the March 19 Administrative Committee and Board meetings were cancelled. She introduced Ms. Angie Naillon, the new Budget and Accounting Manager; Mr. Brian Fischer, appointed as the Assistant Senior Investment Officer-Risk Management and Asset Allocation; and announced that Ms. Alyssa Barada had been promoted from a Secretary Senior to Administrative Assistant 3-Investments. Ms. Whitmarsh said there has been some media interest relating to the Securities and Exchange Commission's (SEC's) announcement that they are investigating how private equity firms charge fees to their limited partners, including several articles in the *Wall Street Journal*, an interview with *Pensions & Investments*, and some public records requests. Mr. Bruebaker has sent letters out to the WSIB private equity general partners to ask if they have been reviewed by the SEC and, if so, if there were any findings as a result of that review. Key practices have been disclosed to the WSIB, and staff believes there are no undisclosed issues; however, staff does not have access to the SEC findings.

[Ms. Holman arrived at 9:35 a.m.]

This legislative session, the WSIB has received a few fiscal note requests but none of significant impact. Ms. Whitmarsh highlighted meetings she attended, including the World Economic Forum. She said the Forum highlights included discussions of expected liquidity challenges as central banks pull back from quantitative easing, technology disruptions, and energy and alternatives investing. In response to Ms. Kuschel's question about cyber security discussions, Ms. Whitmarsh said there was a lot of talk of significant threats that would shock systems, and technology firms are working hard on solutions to stay ahead of threats.

ADMINISTRATIVE COMMITTEE REPORT

Strategic Plan

Chair Frost reported that Ms. Whitmarsh presented the 2015 strategic plan themes to the Administrative Committee at its January meeting. She incorporated the Committee's feedback and would now present the proposed 2015 plan to the Board for consideration.

Ms. Whitmarsh reviewed the multi-year projects still underway from previous strategic planning efforts, introduced new projects, and discussed what Board education has been built in to support members' requests. She reviewed the strategic framework, built to support *Value*, *Support*, and *Capacity* initiatives. The WSIB's goal is to ensure its investment strategies are built to deliver exceptional returns that are supported by stakeholders, and it has the organizational capacity to execute those strategies. The projects rest upon a *Skillful Board*, so ongoing incremental improvements are planned in the areas of meeting management and member education.

Ms. Whitmarsh said the projects still underway include: (1) The Commingled Trust Fund (CTF) performance contribution and attribution analysis. She reported there are still methodologies that contribute to performance, and internal tools and data to evaluate so analytics can be blended with judgement. She expects the project will continue into 2016. (2) Review of how private assets might be used by other asset classes so they can possibly be opened up to other funds, such as the Labor and Industries' portfolio and Department of Retirement Systems' target date strategies.

New *Value* projects include: (1) Implementing the asset class plans, including Public Equity innovations versus resources, Fixed Income's focus on credit and emerging markets in the mid- to long-term, Private Equity's long-term strategies, Real Estate's focus on construction and structure of the portfolio, and Tangible Asset's continued ramping up of that program. (2) Reviewing the Innovation portfolio to see what benefits could be derived if assigned an "owner." Historically, the Innovation portfolio has not been assigned dedicated staff. Staff is currently delegated decision making responsibilities for individual investments in the Innovation portfolio up to 1 percent of the CTF and up to 5 percent for the total Innovation portfolio. Vice Chair Fox asked if the objectives of the portfolio are consistent with those stated when the Board approved it, as the percentage of the CTF could be a lot different today than it was 10 years ago. Mr. Bruebaker said the objectives could be revisited whenever the Board wants. Ms. Whitmarsh said examples of Innovation portfolio investments include the global equity portfolio added in 2007 and the resource equities completion portfolio established in 2011. The current portfolio make-up is resource equity, distressed debt, and mezzanine. In response to Mr. Seely's question, Mr. Bruebaker said the current percentage of Innovation investments within the CTF is approximately 0.36 percent. Mr. Nierenberg and Treasurer McIntire both agreed this is an important project for staff to consider, as staff experience and resources have increased since 2005.

New *Capacity* projects include: (1) Work force strategy projects that were spun off from the succession planning initiative in 2014, which will also look at employee and leadership development to prepare the entire organization for advancement and develop a deep bench. Ms. Whitmarsh said, in addition to two executive team members retiring this year, there are a number of staff nearing retirement within the next decade, and some are holding unique and technical positions. One of the project goals will be to mitigate key person risk and get successors trained. She said an organizational review is also underway. Mr. Nierenberg suggested staff look to other investment organizations that have done a good job building staff capacity. He suggested a few firms, noting that Mr. Charley Ellis also wrote books on these themes and could possibly be consulted. (2) Analyzing fiduciary risk by conducting best practices in implementing SEC regulations, reviewing and monitoring personal trading activities, identifying training needs, and proposing changes to existing policies. (3) Conducting a full review of proxy voting guidelines due to the many changes in processes within the last decade. Board members suggested staff identify and prioritize issues and gain insight on what peers do to benchmark against them.

New *Support* projects include meeting new legislators, expanding the audience for telling the WSIB Story, and supporting members with materials to assist with constituent communications.

Projects relating to the *Skillful Board* include meeting management and Board member education. Staff hopes to leverage the experience of non-voting members, and plans for a robust risk discussion at the July Board meeting. Mr. Nierenberg offered his help with staff board training.

> **Chair Frost moved that the Board approve the 2015 Strategic Plan. Vice Chair Fox seconded, and the motion carried unanimously.**

Quarterly Budget Report
Chair Frost reported that, due to lack of business items, the Administrative Committee did not meet this morning. She asked Mr. Moore to present the Quarterly Budget Report to the full Board for its information.

Mr. Moore reported on the budget status as of December 31, 2014. He described the appropriated and non-appropriated budget categories, the latter of which is not subject to legislative authority. For the appropriated funds, the budget was underspent by 13 percent, with a $2.6 million savings projected, primarily due to staff vacancies and associated savings from no travel. He said five new Investment Officers were hired in June, and recruitments are underway for two more, as well as four support positions. The non-appropriated budget is 9 percent underspent—a $32 million savings. He noted appropriated expenses are tougher to estimate, as they are related to investments, contracted fee levels, and performance.

PRIVATE MARKETS COMMITTEE REPORT

> **Mr. Masten moved that, on the advice of the Attorney General's Office, the Board clarify and affirm its prior approval of the investment of up to $600 million, plus fees and expenses, in TPG Capital Partners Strategic Account, L.P., subject to continuing due diligence and final negotiation of terms and conditions, with the rollover of funds into TPG Partners VII, L.P., subject to continuing due diligence and final negotiation of terms and conditions. Treasurer McIntire seconded the motion.**

Mr. Masten reported at its February 20, 2014, meeting, the Board approved an investment of up to $600 million, plus fees and expenses, in TPG Capital Partners Strategic Account, L.P., with the understanding that the fund was to be an interim fund with uncalled capital rolled into TPG Partners VII, L.P. The interim fund called no capital, and the entire amount was rolled into Fund VII. He said the WSIB's Assistant Attorney General has opined that, while the intent was clear as evidenced in the Private Markets Committee minutes and materials, the motion made in February 2014 was not comprehensive of this intent. Thus, it is requested that the Board clarify its approval of the rollover of the commitment in TPG Capital Partners Strategic Account, L.P., into TPG Partners VII, L.P.

In response to Treasurer McIntire's question, Mr. Bruebaker said that all $600 million of the TPG Capital Partners Strategic Account would be rolled over into TPG Partners VII, and the WSIB's favorable terms in the Strategic Account would also continue to apply to WSIB's commitment to TPG Partners VII. Mr. Ruggels said the initial recommendation was for $600 million to the Strategic Account, which TPG raised as an insurance policy, or an interim bridge fund, in case TPG ran out of capital in Fund VI prior to getting Fund VII up and running. Staff advised the Board at the time of that action the commitment to the Strategic Account most likely would be just an early commitment to Fund VII, with the possibility that some capital would get drawn in the Strategic Account and, if that was the case, whatever was left undrawn would get rolled over. He reported that nothing was drawn in the Strategic Account so the entire amount goes to Fund VII.

The above motion carried unanimously.

PUBLIC MARKETS COMMITTEE REPORT

Mr. Sacks reported the Public Markets Committee met on February 3 to consider an investment policy revision and staff's recommendation for restructuring the public equity emerging markets program.

Other Trust Funds Investment Policy 2.35.200 Revision

Mr. Sacks reported that review by the Board of certain agency policies is required every 3 years. Along with the required review, the Other Trust Funds Investment Policy 2.35.200 has been revised to align with current statute. In 2012, the Legislature passed and the Governor signed Engrossed House Bill 2620, moving 11 different funds from the WSIB to the State Treasurer. The proposed revision reflects the removal of five of those funds from this policy. The policies covering the other six funds have already been revised.

Mr. Sacks moved that the Board approve the proposed revisions to the Other Trust Funds Investment Policy 2.35.200. Ms. Holman seconded, and the motion carried unanimously.

Emerging Markets Manager Search Results and Recommendation

Mr. Sacks reported the Committee also considered staff's recommendation for restructuring of the public equity emerging markets program. Of the six emerging markets managers in the CTF, five are active managers with the goal of providing excess returns over the benchmark. As per the Board-adopted Investment Beliefs, the WSIB will retain active managers only when certain conditions are met and only when there is high conviction in that particular manager's abilities. While passive management is the default allocation for public equity investments, emerging markets is an area where staff feels that passive is not the optimal choice.

In November 2013, Public Equity staff initiated a search to find additional active emerging markets managers for inclusion in the CTF. After much due diligence, staff has recommended the addition of AQR and Brandes for active emerging markets mandates with the WSIB. These firms both have convincing competitive advantages and complement the current WSIB program.

Mr. Masten said he attended the Public Markets Committee meeting to listen to the discussion. He asked to have the single motion to add the two managers bifurcated.

In response to Treasurer McIntire's question about active management, Mr. Sacks said he believes that staff had done good due diligence, he was impressed with the two firms' performance, and believes they would be good additions to the portfolio.

Chair Frost 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. She said the executive session was expected to last about five minutes, at which time the Board would reconvene in open session.

[The Board went into executive session at 10:43 a.m., and reconvened in open session at 10:54 a.m.]

Mr. Paroian discussed the challenges faced during the search to find managers that were still open, with good track records, and that are a match for WSIB. Staff will continue to watch managers and consider options over the next few years to see if further capacity can be added in the future.

Mr. Sacks moved that the Board approve the proposed restructuring of the public equity emerging markets program, as discussed in executive session. Ms. Holman seconded the motion.

Mr. Masten asked to have the motions taken in the reverse order than initially proposed.

Chair Frost tabled the above motion.

Mr. Sacks moved that the Board hire Brandes Investment Partners for the public equity emerging markets program. Ms. Holman seconded the motion.

Mr. Masten said he is somewhat troubled with this recommendation but has decided to support it. He expressed concerns about the risk, particularly their investment in Russia, and in oil and gas. He noted there is potential for great returns, but volatility could be significant. Mr. Paroian pointed out that Brandes is not a standalone manager but, rather, there is a portfolio of 5-6 managers with Brandes and they will have the smallest allocation for the exact reasons articulated by Mr. Masten. Mr. Nierenberg said he shared some of the same concerns but was helped by this particular manager being a long-established firm with widely held ownership, and he was struck by the fact people at the firm have a significant amount of their own money invested in their strategies alongside clients' money.

The above motion carried unanimously.

Mr. Sacks moved that the Board hire AQR Capital Management LLC for the public equity emerging markets program. Ms. Holman seconded the motion.

Mr. Masten said he planned to vote against this manager as he has never been impressed with quantitative approaches and prefers people over programs. He noted such managers have higher stock turnover versus a long-term investment in companies. He questioned whether the previous quantitative firms the WSIB hired were still around and how they had performed. Mr. Paroian noted the WSIB still has both active global equity quantitative managers, Arrowstreet and DE Shaw, that have continued to outperform in the 3-1/2 years since inception of the WSIB's mandate.

The above motion carried, with Mr. Masten voting no.

Chair Frost asked that the Board act on the tabled motion to approve the proposed restructuring of the public equity emerging markets program, as discussed in executive session. The motion carried unanimously.

Chair Frost announced that she re-ordered the agenda, and the Board would hear from fiduciary counsel after a brief recess.

[The Board took a brief recess at 11:10 a.m., and reconvened at 11:22 a.m.]

Ms. Whitmarsh introduced Ms. Lerryn McCullough, new Investment Officer – Real Estate, who came to the WSIB from CalPERS.

EDUCATION SESSION

Fiduciary Counsel Training

Mr. Song presented information on the fiduciary principles under ERISA and state trust law that had developed over the years regarding the consideration of economically targeted investments ("ETIs") by pension trust funds. He discussed the fiduciary duties of prudence, loyalty, diversification and in what circumstances collateral benefits may be considered in selecting investments. He also reviewed court cases that had considered the legality of such investments, and identified operational issues that arise in the assessment of ETIs.

Mr. Seely asked which guidance WSIB should follow regarding divestment proposals given what appeared to be conflicting rulings with reference to the Oregon and Baltimore case examples. Mr. Song said that court rulings in this context will always be very fact specific, and it would depend on the asset allocation of the particular plan at issue and the anticipated financial impact to the specific pension plan. It is difficult to give a hard and fast rule as it depends on the specific circumstances. Since fiduciary investment prudence, however, focuses on the process and procedure by which investment decisions are made, there is guidance that would assist the WSIB in ensuring proper factors are considered in assessing ETI proposals. Mr. Song distributed a Department of Labor Interpretive Bulletin under ERISA that provides guidance in complying with fiduciary prudence and loyalty duties in assessing ETI options by evaluating their impact on diversification, liquidity, and risk/return under an economic analysis. While the WSIB is not subject to ERISA, the fiduciary standards addressed in the Interpretive Bulletin are derived from the common law of trusts and also parallel the standards in the WSIB's internal policy on ETIs. Mr. Song also distributed another handout that addresses what considerations should be taken into account by pension fiduciaries to ensure prudent investment decision-making.

A discussion ensued about special considerations for ETIs, sometimes now referenced as environmental, social, and governance investments, or sustainability investments, and how a trustee can reconcile reputational risk. Mr. Song cautioned that, from a legal perspective, a conservative approach is appropriate that applies applicable fiduciary principles, examines the practices of peer-based funds and focuses on financial data analysis. The economic analysis needs to determine if an ETI proposal is economically equal to or superior to current investments or other options within the applicable asset allocation, taking into account diversification, liquidity and risk/return factors. If that standard is not met, there is no basis for considering non-economic factors. Mr. Masten said the legislative mandate to maximize returns at a prudent level of risk is the WSIB's standard.

[The Board took a brief recess at 12:25 p.m., and reconvened at 12:47 p.m.]

Conflict of Interest/Ethics, Quiet Periods, and Open Public Meetings Act Annual Training and Policy Certification

Ms. Lobdell presented the Board's annual training on ethics, conflict of interests, and the Open Public Meetings Act. She reviewed the guidelines regarding prohibited and *de minimis* use of resources; and avoiding conflicts of interest including use of position, gifts, entertainment, confidential material, insider trading, and recusals. Senator Hewitt asked whether or not he would have to file dual disclosure reports with both the WSIB and the Legislature, which Ms. Lobdell affirmed that additional reporting to the WSIB was needed.

Ms. Lobdell described the concept of "pay-to-play" and how the WSIB has incorporated safeguards to negate any potential for violations. She discussed the history of the Open Public Meetings Act, public notice requirements, regular and special meetings, quorum, and consequences for violations. Messrs. Sacks and Masten asked questions about whether Board members could participate in Committee meetings that are educational in nature. Ms. Lobdell cautioned against participation of non-Committee voting members once a quorum is reached. Ms. Lobdell described quiet periods that apply when procurements are issued or firms are placed on "watch list," per WSIB Policy 2.00.230. She concluded by emphasizing the integrity, professionalism, and ethical behavior pillars of WSIB Policy 2.00.150.

[Senator Hewitt left at 1:17 p.m.]

PERFORMANCE REPORT

2014 Public Equity Annual Performance Discussion

Mr. Paroian introduced his presentation of the 2014 public equity market environment, performance, and the outlook into 2015.

He reported that global equity markets were modest in 2014. The U.S. led equity markets with strong returns, and value did modestly worse than growth. Negative performance for developed markets occurred primarily in Germany, France, and Italy, and Greece and Russia for emerging markets. Energy and materials underperformed for during 2014.

Mr. Paroian reviewed public equity performance for the CTF. He said the CTF has shown steady improvement over the past 7 years but is now showing satisfactory performance over the 1-, 3-, and 5-years, delivering over 50 bps annualized value added over the 5-year period. Long-term, if plus 30-60 basis points is seen, staff would be extremely happy with that. Ms. Holman asked about the composition of the custom benchmark. Mr. Paroian said there is a link to longer-term benchmarks used by the WSIB, and MSCI created a custom benchmark for a U.S. non-taxable entity. Value added returns would likely be 20 bps higher if the WSIB used the same benchmark as everyone else. Mr. Nakahara said it appears no value was added in the down years in the early part of the financial crisis in 2008 and 2009. When Mr. Paroian came to the WSIB, no massive changes were immediately made, but downside protection is a key consideration for staff. Mr. Bruebaker noted the track record inherited by Mr. Paroian was flat to negative. He and his team have turned it around. Mr. Bruebaker added that Public Equity's process in hiring external managers is much longer than Private Equity's because of state regulations.

Mr. Paroian reported on the performance of the U.S. alternative passive mandate, which was funded at the start of April 2014. It lagged slightly but performed a bit better than a value, which is right in line with what staff expect. In response to Mr. Masten's question about what the performance would have done had the money been placed in a different fund, Mr. Paroian indicated it would have done slightly better with a 9.5 percent return versus the 9.1 percent return realized.

Mr. Paroian reviewed that the management style for the CTF within public equity is 60 percent passive, 30 percent fundamental, and 10 percent quant. He described each of the three components, their pros and cons, and discussed how definitions have become less clear over time. He said having a mix of long- and short-term managers with different styles provides good diversification.

Mr. Paroian reported on the performance of the defined contribution (equity portion), including Plan 3, the Deferred Compensation Program, and Judicial Retirement Account. He said the standalone equity funds are managed on a passive basis so have performance that is close to the index.

The Labor and Industries' portfolio, which is comprised of three funds, is passively managed and performing slightly better than their benchmarks. The equity returns are very close among the three funds, varying mostly due to differences in the timing of cash flows.
Mr. Paroian reported on the Guaranteed Education Tuition, which has performance matching the benchmark as expected; the Developmental Disabilities Endowment Fund, which is in line with its passive benchmark; and the Permanent Funds which have a relatively new structure due to stakeholders' request to avoid recognizing capital gains and losses, and to increase current income through dividend yield. Performance for the

1-year has lagged the benchmark, but staff hopes high-dividend yields stocks over the long-term will perform better and the account will better match the benchmark.

Mr. Paroian presented his 2015 market outlook's important principles relating to returns and how markets are driven. He expects to have macroeconomic and market volatility and anticipates increased divergence between markets. Mr. Miller asked when we had last seen equity returns in the U.S. diverge so sharply from the returns in other markets. Mr. Paroian said he would check.

EDUCATION REPORTS
KPMG Audit Issues Conference
Treasurer McIntire reported on the January conference, which was largely focused on corporate audit practices, but also covered security issues. He said the key takeaways were around avenues and targets with cyber security, and to focus on personnel issues versus systems and procedures. He said it is not a matter of *if* it will be an issue, but *when*. He suggested the WSIB spend time thinking about a communication strategy, including who and when to communicate with when a breach occurs, who is responsible, and how to remediate. He said most companies find it beneficial to rotate security auditors, and he would like to continue discussion of this topic at a future Audit Committee meeting.

[Treasurer McIntire left at 2:07 p.m.]

International Centre for Pension Management-Board Effectiveness Program
Ms. Holman reported on the diverse group of program participants which assisted with varying perspectives. Discussions included attacks on defined benefit plans, pension envy, rethinking fiduciary duties, drivers of the financial crisis, and systemic risk. There was a discussion on whether or not Board members should have insurance policies, and Ms. Holman suggested staff check into that. Ms. Kuschel added that attendees took a survey prior to the Program about the challenges of their respective boards, which resulted in conversations about Board turnover and maintaining talented staff.
Ms. Kuschel observed there were no female instructors at the session. Chair Frost said she would pass that observation along to ICPM, as she serves on their board of directors.

PACIFIC PENSION INSTITUTE'S WINTER ROUNDTABLE
Vice Chair Fox said the Roundtable focused on responsible investing. It included discussions on ethics; environmental, social, and governance (ESG) issues and their impact on investing; sustainable accounting; divestment; and sustainable investing. Chair Frost said the next output from this conference would be for staff to put a framework together on the ways the WSIB engages in ESG issues, and there would be more discussion and information to come to the Board in that area.

PERFORMANCE REPORTS – CONTINUED
Quarterly Commingled Trust Fund Performance
Mr. Bruebaker reported that, while the fourth quarter 2014 was not a great quarter performance-wise; however, the CTF continues to be in the position of having earned in excess of 8 percent for every time period except the 10-year. The CTF was up 1.08 percent for the quarter, and up 8.57 percent for the year-end. Since inception, the return is 8.83 percent.

Mr. Bruebaker said, for the implementation value added (IVA) examination, performance was hurt by the allocation decisions within fixed income and the Innovation portfolio, and by manager decisions with fixed income but was offset by public equity managers. He said the portfolio is positioned well for the long term, but lags the benchmark. Against the TUCS universe, WSIB's outperformed in all time periods except the current quarter.

OTHER ITEMS

There was no further business to come before the Board, and the meeting adjourned at 2:29 p.m.

Marcie Frost
Board Chair

ATTEST

Theresa J. Whitmarsh
Executive Director