**APPROVED**

**STATE OF WASHINGTON**
**STATE INVESTMENT BOARD**

Public Markets Committee Meeting
Minutes

June 3, 2003

The Public Markets Committee met in open public session at 1:05 P.M. at the Washington State Investment Board (WSIB) office at 2100 Evergreen Park Drive Southwest, Olympia, Washington.

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| Members Present: | Charles Kaminski, Chair<br>Debbie Brookman<br>Glenn Gorton<br>Jeff Hanna<br>Patrick McElligott<br>Robert Nakahara |
| Members Absent: | Representative Sommers |
| Others Present: | Joe Dear<br>Nancy Calkins<br>Bill Kennett<br>Linda Lester<br>Diana Will<br>Liz Mendizabal<br>Kristi Bromley<br><br>Paul Silver, Assistant Attorney General<br><br>Janet Becker-Wold, Callan Associates<br>Patricia Karolyi, Delaware International Advisors, Ltd.<br>Hamish Parker, Delaware International Advisors, Ltd.<br>Ara Jelalian, Dresdner RCM Global Investors LLC<br>Mark Phelps, Dresdner RCM Global Investors LLC<br>John Plowright, Dresdner RCM Global Investors LLC |

The meeting convened at 1:05 P.M. with Mr. McElligott identifying members present.

**REVIEW AND APPROVAL OF MINUTES –APRIL 1, 2003 AND MAY 6, 2003**

> **Ms. Brookman moved to adopt the minutes of April 1, 2003, and May 6, 2003. Mr. McElligott seconded, and the motion carried unanimously.**

**INVESTMENT CONSULTANTS COMPETITIVE SEARCH CONCEPT DOCUMENT**

Mr. Dear announced that Mr. Bruebaker would not be attending the meeting, due to a severely injured back, and that Ms. Calkins would be filling in for him.

Ms. Calkins provided background on the WSIB's use of the consultant pool, which began five years ago. She said that this process has been a very successful way for the WSIB to work with consultants and has met our specific needs at a low cost. It was determined that a Request for Qualifications and Quotation (RFQQ) process is better suited for the consultant pool than the Request for Proposal (RFP) process. In response to the RFQQ, firms will indicate their qualifications and personnel costs. The consultant firms will then bid as specific projects are announced.

The RFQQ concept document allows new flexibility to add or remove consultants to the pool. It also adds flexibility to separate general investment consulting from specialty consulting. Specialty consulting includes actuarial studies, investment personnel salary surveys, investment/fiduciary education, risk assessment and risk monitoring, and defined contribution consulting. Another area of flexibility built into the concept document is the ability to extend a contract for up to two years if a consultant begins a specific project that is expected to go beyond the five-year term of the contract.

Discussion ensued regarding the savings gained from the use of the consultant pool versus a retainer relationship with a consultant, and the expected interest from the consultant industry for participating in such a pool.

> **Mr. Gorton moved that the Public Markets Committee recommend that the Board approve the Investment Consultant Competitive Search Concept Document. Ms. Brookman seconded, and the motion carried unanimously.**

**PUBLIC EQUITY – EDUCATIONAL SESSION – INTERNATIONAL STYLE CHARACTERISTICS**

Ms. Calkins said that this was the fourth (and second to last) educational session related to the international equity program review. The Committee has heard presentations on transition management, the outlook for international markets, and gaining emerging markets exposure in a diversified retirement fund. The focus for this month's educational session was growth versus value investing, active versus passive investing, and capitalization. In July, Callan Associates will make a presentation on currency approaches and then Callan and WSIB staff will make their respective recommendations regarding the structure of the international program.

**Growth versus Value Investing**

*Dresdner RCM Global Investors LLC (Dresdner RCM)*

Mr. Jelalian reviewed growth investing, stating that growth stock investing focuses on earnings growth as a catalyst for a stock's price movement and that growth investing is not necessarily the opposite of value investing. Until recently, price-to-book ratio was the only consideration for categorizing growth managers in the Morgan Stanley Capital International (MSCI) indices, which is what value managers also look for. How growth investing is defined is an important factor when growth and value investing are compared.

He reviewed the reasons Dresdner RCM believes in growth stock investing, because in the long run earnings growth drives stock prices and the equity markets anticipate earnings growth. Dresdner RCM believes that through fundamental research they can identify the best growth opportunities.

He reviewed implementation issues of evaluating managers (growth or value) and noted that MSCI's new structure for identifying growth and value stocks is an improvement, but still not perfect. As of May 31, 2003, MSCI went from price-to-book being the only consideration for determining if a stock was value or growth to having three factors for classifying value stocks and five factors for classifying growth stocks, with equal weights to historical, current, and forecast data. He said it was important to monitor style-biased managers to ensure there is no style drift and to evaluate performance over a full style market cycle.

*Delaware International Advisors, Ltd. (Delaware)*

Mr. Parker reviewed the impact of the consistency of a manager's investment style on performance. He said that the more style-consistent international funds tend to produce higher returns than less style-consistent funds. Two reasons for this relationship are that: 1) it is likely that the more style-consistent funds exhibit less portfolio turnover and consequently have lower transaction costs, and 2) managers who commit to a more consistent investment style are less likely to make allocation errors than those who attempt to time their style decisions.

[Chair Kaminski was in attendance at 1:31 P.M.]

Mr. Parker said that style classification indices have proved useful in this analysis. He said that the Citigroup Global Equity Style Indices, which use three growth factors and four value factors to decide the classification of a particular stock, have the most robust methodology. Mr. Parker agrees with Mr. Jelalian that the changes MSCI has made will make that a useful style benchmark as well. The growth factors used by Citigroup are EPS growth, sales per share growth, and five-year average internal growth rate. The value factors are price-to-book value, sales price, cash flow per share, and dividend yield. Mr. Parker said that analysis done on fund managers show that the more style-consistent the manager is the better returns they have achieved.

Mr. Hanna commented that the methodology of their analysis was interesting, but it appeared that the results were very time critical.

**Active versus Passive Investing**

*Callan Associates (Callan)*

Ms. Becker-Wold commented on the growth versus value investing discussion; noting that ten years ago international managers did not define their styles as growth or value but rather defined their focus as either top-down or bottom-up. She also noted that stocks change their characteristics and can be classified and held as both value and growth stocks.

She reviewed the current position of the WSIB international equity program and noted that in the spring of 1999 the WSIB made the decision to move from 70 percent passive/30 percent active to 50/50. She said that passive investing has declined in terms of market share in international mandates, primarily as a result of performance. She reviewed the advantages and disadvantages of active and passive investing and compared the costs, performance, and risk/reward of the two styles.

Ms. Becker-Wold noted that deciding how much passive international investing is appropriate in a portfolio depends on numerous factors: plan views of added value from active management, need for liquidity, "quality" of benchmark, peer group sensitivity, and concern about active management coverage (e.g., Japan weighting). She also reviewed how active managers have added value: country deviation from index, style, market capitalization, sector deviations, and holding stock not in the index. She reviewed the effect of country and regional weights deviating from the index and the effect that has on performance.

Ms. Becker-Wold reviewed how the WSIB international managers have performed since inception (July 1, 1999) ranked against Callan's non-U.S. equity style group. All managers, except for the growth managers, have been in the top 50th percentile of all the managers in their style group. Only the two growth managers have unperformed the index over this time period. She reviewed a chart showing the six WSIB developed international managers in a market-value weighted composite. The program and the aggregate, which she believes is the most important valuation criteria for the success of the active program, is in the 30th percentile of Callan's database and has outperformed the benchmark by 430 basis points. The WSIB international developed equity program has beaten the benchmark by approximately 400 basis points, net of fees, per annum since inception. This tells her that this program has been a success.

She reviewed the risk/reward characteristics of the entire WSIB international developed markets program and noted that it is close to the benchmark, but slightly higher. More importantly, the entire WSIB program has performed better than the benchmark. She noted that Dresdner RCM has outperformed the MSCI growth index by about 30 basis points over this period, so they are on average about flat net of fees. Nicholas-Applegate has done slightly better. Both have done so at higher risk even compared to the growth index. She noted that the value managers have beaten the value benchmark by a significant component with a slightly higher risk. In aggregate, the program has done well, on an absolute performance and a risk adjusted basis.

Ms. Becker-Wold reviewed Callan's outlook for active management, noting that the more moderate Japan weight in the index reduces the impact of Japan on relative performance. The MSCI index enhancements make the index harder to beat, but they believe in the fundamental law of active management, which is that there is a higher expected information ratio, so a better risk-adjusted return is a function of skill and breadth. Callan expects active management, especially in international investing, to continue to outperform passive investing.

**Capitalization**

*Callan*

Ms. Becker-Wold said that for this analysis the Citigroup indices were used rather than the MSCI indices for a number of reasons, including the extremely small size of the MSCI small cap index, its lack of historical information, and inferior accessibility to the data for consultants such as Callan. She reviewed the size of the small cap universe, noting that the non-U.S. small cap market is 79 percent of the securities and 20 percent of the market cap of the broad market index, ex. U.S. The total available market capitalization of the non-U.S. small cap universe is $1.4 trillion, which is not huge but is a significant part of the market cap of securities outside the United States.

She reviewed the diversification that international small cap provides by country, region, and sector, the valuation differences between small and large cap stocks, the low correlation of international small cap to U.S. large cap, and its performance patterns. She said that, like international investing in general, international small cap is a good use of active management, with 94 percent of active international managers outperforming the Citigroup international small cap benchmark for the ten-year period ended March 31, 2003. She also reviewed a risk/reward comparison over rolling three-year periods, which showed that small cap was slightly less volatile than EAFE over time.

Ms. Becker-Wold reviewed implementation options. Opportunistic implementation included allowing managers to use smaller cap securities or to gain exposure through a diversified commingled pool. Strategic implementation would be a separate mandate with a dedicated allocation, and would involve determining an appropriate allocation and selecting a benchmark. She reviewed implementation cost considerations, noting that fees, custody costs, and transaction costs could all be higher.

Discussion ensued relative to what constitutes a style market cycle. Ms. Becker-Wold will send WSIB staff a chart that shows the market cycles for growth and value investing. She said that before 1998, growth and value classifications were mostly unheard of with the focus of managers being top-down or bottom-up. The cycle of higher correlations across sectors created the divergence in the growth and value styles, which was unprecedented in the history of international investing.

[The Committee recessed at 2:21 P.M. and reconvened at 2:32 P.M.]

## PUBLIC EQUITY – INVESTMENT MANAGER PORTFOLIO REVIEWS

*Delaware International Advisors, Ltd.*

Ms. Karolyi introduced herself and Mr. Parker. She reviewed organizational highlights of Delaware International, which is a part of Delaware Investments. Mr. Parker and his colleagues manage the WSIB portfolio out of the London office. She provided an overview of the firm, including total assets under management of Delaware International, and assets under management in the international/global equity mandates. She reviewed the organizational chart for the investment team in London, with 36 investment professionals who work under a common investment philosophy.

Mr. Parker reviewed their investment philosophy and methodology, performance characteristics, and portfolio characteristics. He reviewed the defensive characteristics of their portfolio on an annualized basis since inception showing total performance as well as performance for bull and bear markets. He reviewed a risk/return comparison, which depicted a good trade off between risk and return. Mr. Parker reviewed the equity market performance for 2002 and year-to-date 2003 by country and region and reviewed Delaware's performance for the first quarter 2003, year-to-date as of April 30, 2003, and one-year, three-year, and since inception time periods. He reviewed performance attribution and the contributors from currency, market, and stock selection for the first quarter 2003 and year 2002.

Mr. Parker reviewed Delaware's investment strategy, including country allocation, purchasing power parity valuations versus the U.S. dollar, holdings, price-to-earnings ratio, price-to-book value ratio, price-to-cash flow ratio, and dividend yield. He reviewed portfolio holdings as of April 30, 2003, including the top ten holdings, and top ten best and worst performing stocks.

Discussion took place regarding Delaware's performance compared to other value managers, dividend discount models, and their country selection process.

*Dresdner RCM Global Investors LLC*

Mr. Plowright introduced himself, Mr. Phelps, and Mr. Jelalian. He provided an overview of the firm, including assets under management, and noted that asset management is Dresdner RCM's only business activity. He noted that two years ago their parent company was purchased by Allianz to form Allianz Dresdner Asset Management (ADAM), which has three business lines: insurance, asset management, and financial services. He reviewed changes in personnel, including Ian Vose as the new CIO of Dresdner RCM, replacing Bill Price who had been the CIO of ADAM and Dresdner RCM.

Mr. Phelps reviewed performance for the first quarter 2003, May 2003, year-to-date as of May 31, 2003, and one-year, three-year, and since inception time periods. He reviewed the impact of growth and quality on performance, noting that growth stocks, high quality stocks, and large cap stocks all underperformed in 2002 and reviewed a chart showing the style shifts within the equity markets since June 1999.

He reviewed Dresdner RCM's investment philosophy, including stock selection, global research, and team approach. He also reviewed their investment process and portfolio construction. He reviewed their top ten holdings, expected earnings growth per share, decomposition of their tracking error (active risk), portfolio over- and underweights by country and sector, and their outlook for international equity.

Discussion ensued regarding personnel restructuring and their portfolio construction including variances from the index and their approach to risk.

## PUBLIC EQUITY – WATCHLIST UPDATE

Ms. Calkins said that late last week Mr. Bruebaker and she met with the Department of Retirement Systems to talk about the managers in the Deferred Compensation Program. WSIB staff have placed Fidelity Overseas on Watchlist due to underperformance, which Fidelity has indicated was primarily due to stock selection.

Ms. Calkins reviewed three-year performance attribution for the managers on Watchlist.

[Mr. Nakahara was no longer in attendance at 4:24 P.M.]

Discussion ensued regarding performance attribution. Mr. Hanna said that the information presented did not help him understand why the managers made the decisions they did so that the Committee could understand how the processes works and determine if they have a reasonable process. The Committee, staff, and Callan discussed comparing the managers to other managers in their style universe, to the broad benchmark, and reviewing historical track records. Market cycles and personnel changes at Dresdner RCM were also discussed.

## PUBLIC EQUITY – BENCHMARK REVIEW UPDATE

Ms. Calkins said that there were no updates on benchmark changes at this time.

## OTHER ITEMS

There being no further business to come before the Public Markets Committee, the meeting adjourned at 4:41 P.M.