

**STATE OF WASHINGTON
STATE INVESTMENT BOARD**

Public Markets Committee Meeting
Minutes

May 4, 2004

The Public Markets Committee met in open public session at 1:02 P.M. at the Washington State Investment Board (WSIB) office at 2100 Evergreen Park Drive Southwest, Olympia, Washington.

Members Present: Glenn Gorton, Chair
Charles Kaminski
John Magnuson
George Masten
Dave Scott
Representative Sommers
Paul Trause

Members Absent: Jeff Hanna
Robert Nakahara

Others Present: Joe Dear, Executive Director
Gary Bruebaker, Chief Investment Officer
Theresa Whitmarsh, Deputy Director for Operations
William Kennett, Senior Investment Officer – Fixed Income
Nancy Calkins, Senior Investment Officer – Public Equity
Diana Will, Investment Officer – Asset Allocation
Kristi Bromley, Administrative Assistant – Investments

Paul Silver, Assistant Attorney General

[Names of other individuals attending the meeting are not included in the minutes but are listed in the permanent record.]

The meeting convened at 1:02 P.M. with Chair Gorton identifying members present.

REVIEW AND APPROVAL OF MINUTES – APRIL 6-7, 2004

**Mr. Masten moved to adopt the minutes of April 6 - 7, 2004.
Mr. Scott seconded, and the motion carried unanimously.**

PREVENTING INADVERTENT INVESTMENTS IN COMPANIES DOING BUSINESS IN TERRORIST-SUPPORTING NATIONS

Mr. Dear noted that the Public Markets Committee was asked by the Board to review the protections that exist at the federal level and the options available for the WSIB to protect the retirement funds from being inadvertently invested in companies found in violation of U.S. law for illegally doing business with terrorist-supporting nations. Staff and WSIB legal counsel contacted the WSIB's public equity managers regarding how the managers handle this issue and researched existing federal regulatory and enforcement controls. Mr. Dear summarized the key issues and the three potential options available to the WSIB: (1) continue to monitor the issue, oversee managers, and work with others to assess effectiveness of existing and additional federal agency efforts; (2) draft and adopt a policy to guide WSIB staff and money managers on what to do regarding companies found in violation of U.S. law for illegally conducting business with countries that support terrorism; and (3) undertake additional due diligence efforts.

[Mr. Kaminski was in attendance at 1:08 P.M.]

Discussion ensued regarding the potential options available to the WSIB.

Mr. Masten moved that the Public Markets Committee recommend that the Board direct staff to continue to monitor the issues related to preventing inadvertent investments in companies doing business in terrorist-supporting nations, oversee managers, and work with others to assess effectiveness of existing and additional federal agency efforts. Representative Sommers seconded the motion.

Further discussion ensued regarding the WSIB's options, experience of other pension funds, the practices of the WSIB's equity managers, and the importance of the federal government's role in this arena.

The motion carried unanimously.

FRANK RUSSELL SECURITIES, INC. DIRECTED BROKERAGE CONTRACT EXTENSION

Mr. Bruebaker noted that in 2001 the WSIB conducted a competitive search for a directed brokerage agent. The Board selected Frank Russell and entered into a three-year contract with the option of two one-year extensions. The current contract expires on December 31, 2004, and is eligible for the first one-year extension. Frank Russell is doing a very good job for the WSIB in this area and staff respectfully requests that the Public Markets Committee recommend that the Board allow the Executive Director to extend the contract for the first one-year extension.

Mr. Trause moved that the Public Markets Committee recommend that the Board authorize the executive director to extend the contract with Frank Russell Securities, Inc. for one year through December 31, 2005. Mr. Scott seconded, and the motion carried unanimously.

FIXED INCOME ANNUAL REVIEW

Mr. Kennett provided a review of factors that affected the market in 2003, including the low federal funds rate, volatile interest rates, tame inflation, slow employment growth, and rapid second half gross domestic product (GDP) growth. Mr. Kennett noted that the Federal Open Markets Committee met on May 4 and kept the federal funds rate at one percent while indicating that rates would go up at a measured pace. Mr. Kennett reviewed the interest rate changes in the year to March 31, 2004, the ten-year treasury yield over the past seven years, and treasury bellwether returns. He also reviewed the returns for the Lehman Universal and Lehman Aggregate indices over the one-, three-, five-, and ten-year periods. Mr. Kennett noted that high yield and emerging markets were the best performers and stated that the Commingled Trust Fund Fixed Income portfolios were underweight high yield and overweight emerging markets. He also noted that auto and telecom bonds are not held in the portfolios.

Mr. Kennett provided a market outlook for 2004, including expected strong GDP growth, increased inflation, increased employment, higher interest rates, and expected fixed income returns for the year. Risks to the portfolio were reviewed, including terrorism and related uncertainties, China overheating, and the weak U.S. dollar. The overall fixed income portfolio strategies were reviewed: maintain short duration, maintain exposure to treasury inflation protected securities, remain underweight agencies, add to mortgage holdings, and remain underweight high yield bonds and high beta investment grade credits.

Mr. Kennett reviewed the assets under management for the various fixed income portfolios, allocations to fixed income sectors, and the fixed income trading activity for all funds for the year ended March 31, 2004. He reviewed the goals, performance, summary statistics, and sector statistics for the various fixed income portfolios. He addressed the performance issues of the Bond Market Fund and stated that the current credit quality of the fund is high and the duration short in anticipation of higher interest rates.

Discussion ensued regarding the number of issuer names monitored by the Fixed Income staff and the need for additional staff in the unit.

HORIZON FUNDS ANNUAL REVIEW

Ms. Will provided a description of the three Horizon Funds and reviewed the target allocation to cash, fixed income, U.S. equities, and non-U.S. equities for each fund. She reviewed the history of the Horizon Funds, which first opened to participants in September 2000, and reviewed the growth of assets, participant distribution, and the percentage of assets for the five plans that have investments in the Horizon Funds.

Ms. Will reviewed performance of the three Horizon Funds for the quarter, one-year, three-year, and since inception time periods. She stated that the Horizon Funds were placed on watchlist on February 2, 2004, for performance reasons and reviewed the performance attribution of each fund, including benchmark return, rebalancing tracking error, and tracking error from securities

(manager returns). She then reviewed the performance of the underlying managers for each asset class that comprise the Horizon Funds.

QUARTERLY WATCHLIST REPORT

Mr. Bruebaker provided the quarterly watchlist report for the Committee's information. He highlighted changes from the previous report, noting that the international equity managers that are being replaced as a result of the international equity portfolio restructuring were removed from the watchlist. The Fidelity Overseas Fund was also removed from watchlist due to improved performance. The Horizon Funds and the Bond Market Fund were placed on watchlist in February due to performance; as of April 30, 2004, the performance for those funds shows signs of improvement.

OTHER ITEMS

There being no further business to come before the Public Markets Committee, the meeting adjourned at 2:09 P.M.