

**STATE OF WASHINGTON
STATE INVESTMENT BOARD**

Public Markets Committee Meeting
Minutes

November 2, 2004

The Public Markets Committee met in open public session at 1:00 P.M. at the Washington State Investment Board (WSIB) office at 2100 Evergreen Park Drive Southwest, Olympia, Washington.

Members Present: Glenn Gorton
Jeff Hanna
Charles Kaminski
John Magnuson
George Masten
Robert Nakahara
Dave Scott
Representative Sommers
Paul Trause

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

Paul Silver, Assistant Attorney General

Humphrey Carey, F&C Emerging Markets Ltd.
Ryan Murphy, F&C Emerging Markets Ltd.
Arjun Divecha, Grantham, Mayo, Van Otterloo & Co. LLC
Wendy Malaspina, Grantham, Mayo, Van Otterloo & Co. LLC
Peter Clark, Schroder Investment Management North America Inc.
Allan Conway, Schroder Investment Management North America Inc.
Connie Moak Mazur, Schroder Investment Management North America Inc.

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

The meeting convened at 1:00 P.M. with Chair Gorton identifying members present.

REVIEW AND APPROVAL OF MINUTES – OCTOBER 5, 2004

Mr. Masten moved to adopt the minutes of October 5, 2004.

Mr. Scott seconded, and the motion carried unanimously.

**INTERNATIONAL EQUITY EMERGING MARKETS INVESTMENT MANAGER
PORTFOLIO REVIEWS**

Ms. Calkins noted that three of the four active international emerging markets investment managers would present portfolio reviews to the Committee: F&C Emerging Markets, Ltd.; Grantham, Mayo, Van Otterloo & Co. LLC; and Schroder Investment Management North America Inc.

F&C Emerging Markets Ltd. (F&C)

Mr. Murphy and Mr. Carey introduced themselves. Mr. Carey provided a review of F&C's investment philosophy, noting the importance of country selection and risk control. F&C's investment process involves a team approach with a top-down focus and proprietary research at the country, sector, and stock level; portfolio construction is undertaken relative to a benchmark. Mr. Carey provided additional information regarding F&C's portfolio construction including country and stock selection and risk controls.

Mr. Carey provided an organizational overview, including ownership structure, reviewed the recent merger between F&C and ISIS, and noted the commitment of the management team and stability of the investment team.

[Mr. Trause was in attendance at 1:15 P.M.]

Mr. Carey provided a review of the portfolio, including performance, attribution, key portfolio activity, geographical breakdown, major country bets, top ten holdings, top five security over and underweights, and top ten best and worst performing stocks during the third quarter of 2004. [Mr. Masten was no longer in attendance at 1:25 P.M.]

Mr. Carey provided a market review, noted expected sustainable outperformance in emerging markets for the next two to three years, and reviewed concerns F&C had in the second quarter and their outlook for the second half of 2004.

Discussion ensued regarding F&C's portfolio holdings and strategy, merger with ISIS, organizational structure, and performance.

Grantham, Mayo, Van Otterloo & Co. LLC (GMO)

Ms. Malaspina introduced herself and Mr. Divecha. Ms. Malaspina presented an organizational overview, including office locations, value orientation, focus on research and risk control, ownership structure, stability of investment team, assets under management, investment strategies, and emerging markets team.

Mr. Divecha reviewed GMO's investment objectives, including expected returns, portfolio characteristics, and risk controls. He reviewed GMO's investment philosophy, which is focused on country selection, value, momentum, risk control, and team experience, and provided an overview of the emerging markets investment process, including country selection, security evaluation, portfolio construction, and risk management.

Mr. Divecha reviewed GMO's emerging markets portfolio positioning, including country weightings and reasons for the weighting decisions; portfolio characteristics as of September 30, 2004, including sector and regional allocations and valuation measures; top ten holdings; performance attribution; and emerging markets outlook.

Discussion ensued regarding the factors contributing to GMO's performance (country selection, value, and momentum) and possible changes in the emerging markets.

Schroder Investment Management North America Inc. (Schroder)

Ms. Mazur, Mr. Clark, and Mr. Conway introduced themselves. Mr. Conway joined Schroder two weeks ago to head up the emerging markets products. Mr. Clark provided an organizational update, including office locations and experience of team members.

Mr. Conway spoke to changes he has put in place over the past two weeks and those he will put in place over the next few weeks. He reviewed process enhancements that he is implementing, including re-engineering country allocation process, re-orientating research, and introducing supplementary risk controls. He will recruit four to five senior people to supplement the existing team and fill the losses experienced earlier this year and will implement a rigorous quantitative model for the investment process. Mr. Conway noted a lack of strong communication between analysts and portfolio managers in the past and described ways he will develop a strong connection between research and portfolio construction. All team members will be required to attend and actively participate in monthly strategy sessions and risk control will be tightened significantly.

Mr. Clark reviewed performance including attribution from country and stock selection, and Mr. Conway provided a market outlook and reviewed Schroder's country and sector weightings as of September 30, 2004

Discussion ensued regarding the outlook for emerging markets, turnover in fund managers and analysts, and team buy-in to Mr. Conway's changes, which include increased individual accountability within the existing team culture.

[The Committee recessed at 3:15 P.M. and reconvened at 3:30 P.M.]

EMERGING MARKETS MANAGER DISCUSSION

Mr. Bruebaker noted that one of the objectives of the new international equity structure was to have the ability to overweight or underweight emerging markets in relation to the Morgan Stanley Capital International All Country World Index ex U.S. by setting a fixed 5 percent allocation to emerging markets and allowing the developed markets managers to opportunistically invest in emerging markets. Previously, the portfolio could only be overweight the emerging markets weighting in the index. However, four of the new developed markets managers do not invest in emerging markets in any material way so now the portfolio can only be underweight emerging markets in relation to the index. Staff recommends that a specified emerging markets asset range of between 5 and 10 percent replace the current static target of 5 percent. Annually, staff will select a target within the range and rebalance based on a cost/benefit analysis that considers transaction costs. The target for the current fiscal year would be 6 percent. Currently, the WSIB has a 9.8 percent allocation to emerging markets, which equates to a \$249 million overweight in this asset class. To reduce this overweight to the 6 percent allocation, staff recommends terminating Schroder and reducing the current allocations to F&C and Capital International, Inc. (Capital).

Discussion took place regarding the process for setting a target for emerging markets within the proposed 5 – 10 percent range. The Committee requested that staff drill down further into F&C's and Capital's investment process and report back at the December 7 Public Markets Committee meeting.

Mr. Scott moved that the Public Markets Committee recommend: (1) establishing an emerging markets allocation range of 5 – 10 percent to be reset each year and rebalanced by staff based on a cost/benefit analysis considering transaction costs; and (2) terminating Schroder Investment Management North America for performance and organizational concerns. Representative Sommers seconded, and the motion carried unanimously.

PUBLIC MARKETS COMMITTEE 2005 MEETING SCHEDULE

Mr. Bruebaker presented the proposed Public Markets Committee 2005 meeting schedule to the Committee.

Mr. Trause moved that the Public Markets Committee accept the proposed 2005 meeting schedule. Mr. Scott seconded, and the motion carried unanimously.

Mr. Kaminski noted his preference for having educational sessions for the members at the Committee level rather than at the full Board level when it makes sense. Mr. Dear stated that staff would work on Mr. Kaminski's suggestion.

**DEFERRED COMPENSATION PROGRAM AND JUDICIAL RETIREMENT
ACCOUNT INTERNATIONAL EQUITY OPTION**

Mr. Bruebaker provided an update to the information he presented in October to the Committee regarding the issues surrounding the international equity option in the Deferred Compensation Program (DCP) and Judicial Retirement Account (JRA) currently managed by Fidelity.

Mr. Bruebaker stated that staff will recommend replacing the Fidelity international option in the DCP and JRA, primarily for performance reasons, and will present a Request for Proposal concept document for the international option at the December 7 Public Markets Committee meeting. He noted that staff would continue to work closely with the Department of Retirement Systems on development of the RFP, which will have a tight but doable schedule of having a new option in place April 1, 2005.

QUARTERLY WATCHLIST REPORT

Mr. Bruebaker noted that the third quarter Watchlist report was provided in the meeting packet for the Committee's information; there have been no changes to the report.

OTHER ITEMS

Discussion ensued regarding the recent issues surrounding Merck. Mr. Silver informed the Committee that the WSIB was already a member of a class action lawsuit initiated in November 2003.

There being no further business to come before the Public Markets Committee, the meeting adjourned at 4:02 P.M.