APPROVED

STATE OF WASHINGTON
STATE INVESTMENT BOARD

Public Markets Committee Meeting
Minutes

November 1, 2005

The Public Markets Committee met in open public session at 12:50 P.M. at the Washington State Investment Board (WSIB) office at 2100 Evergreen Park Drive Southwest, Olympia, Washington.

Members Present:	Dave Scott (Acting Chair) Glenn Gorton (via teleconference) Jeff Hanna Charlie Kaminski John Magnuson
Members Absent:	George Masten Robert Nakahara Representative Sommers Gary Weeks
Other Board Members Present:	Debbie Brookman Sandy Matheson Pat McElligott
Others Present:	Joe Dear, Executive Director Gary Bruebaker, Chief Investment Officer Theresa Whitmarsh, Deputy Director for Operations Liz Mendizabal, Public Affairs Director Shawna Killman, Internal Auditor Beth Vandehey, Compliance Director Nancy Calkins, Senior Investment Officer – Public Equity Diana Will, Senior Investment Officer – Asset Allocation Bill Kennett, Senior Investment Officer – Fixed Income Kristi Bromley, Administrative Assistant – Investments Paul Silver, Assistant Attorney General Bruce Clarke, Arrowstreet Capital Peter Rathjens, Arrowstreet Capital Fred Dopfel, Barclays Global Investors Steve Rogers, Barclays Global Investors David Fisher, The Capital Group Paula Pretlow, The Capital Group Dino Davis, Fidelity Investment Management

Kurt Winkelmann, Goldman Sachs Asset Management
Pat Sullivan, Goldman Sachs Asset Management
Mel Lindsey, Julius Baer Investment Management
Richard Pell, Julius Baer Investment Management
Robert Vishny, LSV Asset Management
Keith Bruch, LSV Asset Management
Hamish Parker, Mondrian Investment Partners
Patti Karolyi, Mondrian Investment Partners
Dan Peirce, State Street Global Advisors
Craig Scholl, State Street Global Advisors
Neil Tremblay, State Street Global Advisors
George Greig, William Blair & Company
Stephanie Braming, William Blair & Company

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

The meeting convened at 12:50 P.M. with Acting Chair Scott identifying members present.

REVIEW AND APPROVAL OF MINUTES – SEPTEMBER 12-13, 2005

> **Acting Chair Scott announced that adoption of the September 12-13, 2005, minutes were deferred to the next Public Markets Committee meeting due to the lack of quorum.**

2006 MEETING SCHEDULE

> **Acting Chair Scott announced that adoption of the 2006 Meeting Schedule was deferred to next meeting to the lack of quorum.**

EDUCATION SESSION – DISCUSSION ON INTERNATIONAL INVESTING

Mr. Bruebaker referenced the previous education sessions the Committee and Board have participated in that led up to the international equity manager search and the strategic asset allocation decision and noted the timeliness of this session given the increased allocation to international equity. He introduced the first topic, Macroeconomics and the Challenge of Investing in an Era of Low Returns, and noted the Board's objective of earning an 8 percent nominal return for the defined benefit assets.

Mr. Rathjens, Arrowstreet Capital, reviewed the short- and long-term trends that are affecting returns. He noted the importance of diversification and exploiting mean reversion through active management. Mr. Peirce, State Street Global Advisors, reviewed the overall performance of the U.S., European, Japanese, and emerging markets. In the U.S., valuations pose a challenge for meeting the 8 percent return hurdle. International markets look to provide the best opportunity to generate returns in excess of 8 percent. Mr. Pell, Julius Baer Investment Management, noted the increased focus on pension funds and the asset/liability framework and cautioned against the tendency to increase risk tolerance when expected rates of return are low and pay too much for high risk assets while underpaying for low risk assets. International markets are less efficient than U.S. markets and over the long term international investing with well-selected managers will pay off. With increased globalization and narrowed risk differential, the developed markets/emerging markets decision is particularly critical.

[Mr. Magnuson was in attendance at 1:04 P.M.]

Discussion continued on this topic and focused on the importance of broad diversification, movement of countries from emerging markets to developed markets, the globalization of the economy, volatility and the effect of hedge funds, and the Japanese market.

Mr. Bruebaker noted the evolution of the discussion to the next topic, international investing, and Mr. Fisher, The Capital Group, continued the discussion by providing a historical view on the Chinese and Indian economies. Global investing is attractive as it allows the money managers to maintain positions in companies where they have the highest conviction. Mr. Parker, Mondrian Investment Partners, stated that Mondrian likes the flexibility of investing opportunistically in emerging markets. He noted that some of the difficulties experienced in the U.S. also impact the outlook for international equities, this includes rising interest rates and inflation. There are encouraging signs at the company level in Japan and continental Europe. China and India, in Mondrian's view, are expensive and do not merit more than market weighting.

[Mr. McElligott was no longer in attendance at 1:59 P.M.]

Discussion continued regarding the China, India, and Japan markets, importance of corporate governance in emerging markets, international versus global investing, efficiency levels and performance of international and U.S. markets, mean reversion, and the effect hedge funds have had on the markets.

[The Committee recessed at 2:19 P.M. and reconvened at 2:32 P.M.]

Mr. Bruebaker introduced the next topic, Long Only Constraints, and noted that the WSIB continually looks for additional ways to meet or exceed the financial objectives of those we serve and removing constraints might aid that goal. Mr. Winkelmann, Goldman Sachs Asset Management, noted some issues related to relaxing the long only constraint including the structural changes that have resulted in a decrease in cross-sectional volatility. He noted that increasing tracking error targets is an alternative to relaxing long only constraints. It is critical that managers must demonstrate ability to manage short constraints and have good risk management systems.

Mr. Fisher noted that managing short constraints might change the nature of the relationship between analysts and the companies they follow, with information transparency potentially at risk. Mr. Winkelmann also noted that not every investment manager's system would align with managing short constraints and managers would have to be able to quantify their views. Mr. Pell stated that when a manager is long and wrong, the problem gets smaller, but when a manager is short and wrong, the problem gets bigger. Mr. Davis, Fidelity Investment Management, stated that philosophically an underweight relative to the index is a short but to quantify a negative view on a company is different and impacts the trading desk and research structure as well as the relationship with the companies.

Mr. Parker stated that asking analysts to quantify "when" something is likely to happen is contrary to views as long term investors, as such Mondrian does not view the long only constraint as a constraint. The ability to effectively short companies is a skill set in itself and would change business relationships.

Mr. Scholl, State Street Global Advisors, noted that they have the ability to go short for some of their clients and find that it can be a good source of diversification. Mr. Bruebaker asked which managers would like to have the long only constraint removed and Julius Baer, State Street Global Advisors, Goldman Sachs, and Barclays answered in the affirmative. Mr. Hanna observed that "black box" quantitative managers are most comfortable with removing the long only constraint as that is a something they do as part of their normal process.

Mr. Vishny, LSV Asset Management, began the Value versus Growth discussion noting the importance of that evaluation in strategic asset allocation decisions. He noted that, over long time periods, value consistently outperforms growth especially in the less efficient areas such as small cap. LSV believes in mean reversion at the company level and, from a behavioral finance perspective, people overpay for future growth opportunities. Value stocks are less risky and less subject to investor sentiment and trade on low multiples of current earnings rather than future expectations. Value portfolios perform better in down markets than growth portfolios. This persists because of people's short time horizons and the tendency to maintain a low tracking error since that is what they are measured against. When more emphasis is placed on capital preservation rather than benchmark tracking error portfolios will have more of a value tilt.

Mr. Greig, William Blair & Company, stated that growth is a part of global portfolios. Means of production, supply chains, and consumer aspirations are becoming more globalized and all drive growth strategies in growth companies in markets at every income level. These aspects of globalization create opportunities for growth strategies to add value. The growth and return expectations that companies have for themselves is a key component of this as is improved corporate governance. Mr. Rathjens stated that while value outperforms over the long term, core managers are able to exploit the growth/value cyclical variation.

Discussion continued regarding the tendency of value stocks to perform better in bear markets, index construction, and sector correlation.

Mr. Bruebaker introduced the Currency Management topic by noting that the WSIB currently does not hedge currency exposure as the theory is that, at best, it is a negative sum game over the long term. As the Board's international exposure continues to increase across the asset classes it is time to see if this theory has changed. Mr. Winkelmann noted that currency can be a great place for an active manager to add value and a good long term position is high currency hedge ratio with room for significant currency overlay as a source of alpha. Mr. Dopfel, Barclays Global Investors, stated that in an international mandate the effect of currency does wash out over time as evidenced by the EAFE hedged versus EAFE unhedged over the past 18 year period. The hedging policy decision should be made by investors as part of their strategic asset allocation decision while active currency management is a separate decision and attractive if you can identify skillful managers.

Mr. Greig began the next topic, Possible Shocks, by stating that "surprises" are difficult to forecast while a "shock" is a major change in a trend that could and will have significant impact on the investment environment. Three potential risks that are cause for concern are: (1) environmental stress, including things such as contagious diseases, CO_2 emissions, over utilization of resources, and affects of over exploitation in the emerging markets of productive natural resources. In a way, these are not shocks but are rather inevitable as we will have to deal with constraints on dynamic growth environments that we have not had to think of much previously. This is going to change the way we look at the investment environment and provide new risks and opportunities. (2) emergence of market economies around the world, particularly China and Russia, where there is not yet a capitalist environment. Can there be growth market-based systems without democracy? (3) imbalance between U.S. and the rest of the world, whether we can reach global equilibrium, and the pains associated with doing so.

Mr. Peirce stated that while the markets are in position to be relatively resistant to shocks, potential stress areas include political problems, natural disasters, and global imbalance. Mr. Pell commented that some type of shock might be the way out of the current low return trap.

Mr. Vishny began the discussion on Behavioral Finance, which is a branch of financial research that assumes market inefficiencies and investor behavior create opportunities for higher returns and lower risks. Certain things limit people from taking advantage of these opportunities; this is the interesting component of behavioral finance and is why the opportunity does not go away if everyone understands the anomaly. Value investing is an example and the issue there is that people have short time horizons so tracking error becomes more important than capital preservation. Lessons learned from behavioral finance are: (1) don't assume return comes with risk; (2) base strategic decisions on long series of data points; (3) move away from policy benchmarks, which would then lead to increased focus on capital preservation versus tracking error.

Mr. Dopfel noted that if investors are indeed irrational in predicable ways then there should be a way to exploit that. Behavioral finance provides a mechanism to do just that and is why managers have an interest in this area.

Discussion ensued regarding the impact of behavioral finance on collective decision making versus individual behavior.

Mr. Bruebaker noted his appreciation for the managers' active participation in the educational session.

OTHER ITEMS

There being no further business to come before the Public Markets Committee, the meeting adjourned at 4:04 P.M.