APPROVED

WASHINGTON STATE INVESTMENT BOARD
Public Markets Committee Meeting Minutes
February 6, 2007

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:	Dave Scott, Chair Senator Lisa Brown Charlie Kaminski John Magnuson (via teleconference) Robert Nakahara David Nierenberg Mason Petit Judy Schurke
Members Absent:	Representative Helen Sommers
Other Board Members Present:	George Masten
Others Present:	Joe Dear, Executive Director Gary Bruebaker, Chief Investment Officer Liz Mendizabal, Public Affairs Director Nancy Calkins, Senior Investment Officer – Public Equity Steve Lerch, Research Director Diana Will, Senior Investment Officer – Asset Allocation Bill Kennett, Senior Investment Officer – Fixed Income Kristi Bromley, Administrative Assistant – Investments Kyle Crews, Assistant Attorney General Janet Becker-Wold, Callan Associates Michael O'Leary, Callan Associates

[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 Scott identifying members present.

REVIEW AND APPROVAL OF MINUTES – JANUARY 10, 2007

Mr. Petit moved to adopt the January 10, 2007, Public Markets Committee minutes. Ms. Schurke seconded, and the motion carried unanimously.

FIXED INCOME ANNUAL PORTFOLIO REVIEW

Mr. Kennett introduced himself and provided a 2006 market review, including Federal Open Market Committee tightening, GDP growth, housing market, employment statistics, inflation rates, business investment, trade deficit, consumer price index, oil prices, and global growth.

[Senator Brown and Mr. Kaminski were in attendance at 1:06 p.m.]

Mr. Kennett reviewed the 10-year treasury yield and noted the reduced duration of the retirement fixed income portfolio. He reviewed the 10-year credit spreads, which are currently tight, and stated that he does not believe investors are being compensated for the risk taken. The fixed income portfolio credit holdings are very defensive at this time. He also reviewed the interest rate changes and returns for Treasuries and the Lehman Aggregate and Lehman Universal indices. Mr. Kennett noted that the yield curve is inverted, which historically has been indicative of a recession. However, while the yield curve is indicating a recession, credit spreads are showing that as far as corporations are concerned everything is great – the explanation for this might be global liquidity.

Mr. Kennett provided a market outlook for 2007, noting his expectation that global growth will slow slightly, but remain healthy. The U.S. will have below trend growth with the housing market decline spilling over to consumer spending. Mr. Kennett expects higher unemployment and the Federal Reserve to be on hold for at least the first 6 months of the year. Inflation is still the Fed's chief concern, with core inflation at the upper end of their comfort zone. The Bank of Japan and the European Central Bank will raise rates. He expects interest rates to continue to be range bound until there is some catalyst for change, which he is not seeing at this time.

Mr. Kennett reviewed the portfolio strategy and noted the shortened durations, which are now close to neutral. Due to tightening credit spreads, the portfolios are defensive but still a little overweight. He expects to add mortgages as the year progresses. He reviewed the market value of the fixed income portfolios, which totaled $24.7 billion as of December 31, 2006, sector allocations, and trading activity across all funds.

Mr. Kennett reviewed the goals, performance, and fund statistics for some of the various fixed income portfolios: Retirement Fund, Labor and Industries' Funds, and the Intermediate Bond Fund.

HORIZON FUNDS ANNUAL PORTFOLIO REVIEW

Ms. Will introduced herself and presented the WSIB Horizon Funds Annual Report. The Horizon Funds are comprised of three different funds with three distinct levels of risk and return and are composed of varying percentages of four asset classes: cash; fixed income; U.S. equity; and international equity. She reviewed the target asset allocations for each of the three Horizon

Funds, provided a history of the funds, and reviewed the growth of assets. Ms. Will reviewed total return and performance attribution for each fund and reviewed the performance of the underlying managers.

Discussion ensured regarding cash management, improved performance seen since implementing trading restrictions in the international equity component of the Horizon Funds, and the target allocations for the funds.

CONTRACT AMENDMENTS – INTERNATIONAL EQUITY DEVELOPED MANAGERS

Ms. Calkins introduced herself and reviewed the reasons for staff's request to increase the contract ceilings for the international equity developed markets managers. In addition to good performance in international equities, the Board recently increased the allocation to international equities from 15 percent to 23 percent, which also increased the market values of the portfolios. The fee structures have not changed, but rather the size of the assets under management have grown. Because formal action by the Board was required to increase the contract ceilings, staff is also proposing that the contracts with Arrowstreet Capital, LP; Barclays Global Investors, N.A.; Capital Guardian Trust Company; Pyramis Global Advisors Trust Company; and William Blair and Company be extended so that all the international equity manager contracts expire June 30, 2009.

Chair Scott moved that the Public Markets Committee recommend that the Board authorize the executive director to (1) extend the contracts of Arrowstreet Capital, LP; Barclays Global Investors, N.A.; Capital Guardian Trust Company; Pyramis Global Advisors Trust Company; and William Blair and Company to expire June 30, 2009, and (2) increase each of the international equity developed markets managers' contracts expenditure ceilings to the total contract amounts depicted in the table below.

Contract Name	Contract Number	Total Contract Amount ($ in Millions)
Arrowstreet Capital, LP	04-006	$20.70
Barclays Global Investors, N.A.	04-013	$18.20
Capital Guardian Trust Company	04-004	$20.30
Goldman Sachs Investment Company	04-014	$22.10
Julius Baer Investment Management	04-024	$24.80
LSV Asset Management	04-027	$21.80
Mondrian Investment Partners	04-023	$20.70
Pyramis Global Advisors Trust Company	04-005	$15.40
William Blair and Company	04-025	$21.50

Senator Brown seconded, and the motion carried unanimously.

LIFE CYCLE FUNDS DISCUSSION

Mr. Bruebaker introduced himself and reviewed the five main challenges defined contribution investors face: making the time available to manage investment choices; knowing how they feel about risk and what that means; understanding all available investment options; making the optimal investment allocations; and changing their investment mix over time. The options available to defined contribution participants today require the participant to customize and make more selection decisions, which requires a bigger time commitment and active involvement. This path is right for some participants, but not most. Professionally managed retirement target date funds would provide participants with an option that provides full diversification in one fund and requires inactive involvement. The trend of plan sponsors toward retirement target date funds is consistent with several behavioral studies which found that a large majority of participants never change their allocation after the initial decision. In retirement target date funds, the fund manager automatically changes the mix over time. Participants can monitor, but they do not need to actively manage the process. This path is right for most participants, but not all.

The three balanced Horizon Funds available to participants today are risk-based funds. A concern with static balanced funds is that the asset allocation never changes. Presumably, younger participants would chose the Long Horizon Fund and move to the Mid- and Short-Horizon Funds as they get closer to retirement age. However, studies have shown that this is not actually what happens. Studies show that 86 percent of participants fail to rebalance over time as it is difficult for participants to understand the risk decisions they need to make. When participants don't change their asset allocation, it usually means they are underinvested in the early years or they are over invested in the later years relative to the amount of risk they are taking in their investment portfolio. Generally, individuals tend to under invest which means they take on the risk of outliving their money.

The benefits of retirement target based funds are that there is appropriate risk level for every age, it is easier for participants to understand the "one stop shopping" offered, and the critical asset allocation and rebalancing decisions are placed with investment professionals.

In January, WSIB staff presented the concept of retirement target based funds with the Employees Retirement Benefits Board (ERBB), whose statutory role is to recommend desired option changes to the WSIB, which in turn has the responsibility to determine what options to offer participants. The ERBB unanimously requested that the WSIB actively pursue evaluating the replacement of the static balanced funds with age-based funds. Staff will conduct a widespread competitive process working closely with the Department of Retirement Systems and will look at internal and external proposals.

Discussion ensued regarding rebalancing, the Department of Retirement Systems' participant education process, and the ability of participants to actively manage their investments if they want while have this option which would better serve the majority that do not make asset allocation decisions over time.

[Mr. Nierenberg was no longer in attendance at 1:52 p.m.]

> **Mr. Petit moved that the Public Markets Committee recommend that the Board approve the commencement of a competitive process in concert with the Department of Retirement Systems to evaluate and potentially replace the Horizon Funds with retirement target date funds. Senator Brown seconded, and the motion carried unanimously.**

SECURITIES LENDING PROVIDER
Chair Scott announced a change to the order of the agenda.

Ms. Whitmarsh introduced herself and noted that staff requests that the Public Markets Committee defer the award of the securities lending provider to the February 15 Board meeting. The WSIB issued a Request for Proposal for global custodian and securities lending services in November 2006. Staff has completed its review of the proposals, conducted site visits with two finalists, and, after further due diligence, is prepared to bring its finalist recommendation to the February Board meeting. While the selection process yields one bank for both services, two contracts are actually issued: one by the WSIB for securities lending and one by the State Treasurer for custody services. The Public Markets Committee, by its charter, has responsibility for reviewing and approving staff's recommendation for the securities lending provider. Because the WSIB has chosen to make securities lending services a sub-set of the broader set of custodial services, staff would like to defer the selection until the broader custody provider discussion at the Board meeting.

> **Chair Scott moved that the Public Markets Committee defer the award of the securities lending provider to the February 15, 2007 Board meeting. Mr. Petit seconded, and the motion carried unanimously.**

[The Committee recessed at 1:58 p.m. and reconvened at 2:10 p.m.]

[Mr. Magnuson was no longer in attendance at 1:58 p.m.]

DISCUSSION REGARDING UPCOMING EDUCATIONAL SESSIONS AND SPECTRUM OF ACTIVE/PASSIVE MANAGEMENT OPTIONS
Mr. Bruebaker noted that the current contract with Barclays Global Investors for U.S. equity index-related funds expires on December 31, 2007. Prior to the commencement of the procurement process, staff and Callan Associates will review the current U.S. equity program structure with the Committee and suggest options for the active/passive mix based on the investment beliefs of the Board. Mr. Bruebaker stated that this presentation would kick off the discussions on active versus passive investing in the U.S. equity portfolio and would provide the framework for future educational sessions in April and May, leading to staff's recommendation in June relative to the structure of the U.S. equity portfolio.

Ms. Calkins introduced herself and reviewed the spectrum of passive and active management, from pure indexing to very active strategies. She reviewed the characteristics of passive and active management and the WSIB's history of active management in U.S. equity since 1991. In

May 1997, the Board decided to passively manage the entire U.S. equity portfolio. Since that time, the Board has reduced its U.S. equity allocation by 13 percent and shifted toward additional active management in international equity and private equity strategies. Ms. Calkins reviewed the reasoning behind the Board's 1997 decision, including performance of the active managers, lack of manager performance persistence, more efficient use of limited staff resources, and managing risk. She reviewed the Board's experience with indexing the U.S. equity portfolio, including performance, cost, tracking error, turnover, diversification, and flexibility.

Ms. Calkins noted that after the 1997 decision, the Board looked at this topic again in 2001 as part of the asset allocation study, in 2002 in terms of enhanced indexing, in 2005 by allocating 25 percent of the U.S. equity portfolio to enhanced, and now again with this review of the portfolio structure.

Mr. Nakahara noted the importance of unquantified risks (e.g., bad publicity) as well as quantified risks in evaluating portfolio structure.

Ms. Becker-Wold and Mr. O'Leary introduced themselves and the objectives for their presentation: discuss role of active and passive management in public equity portfolios, especially U.S. equity, and discuss how the WSIB looks relative to its peers, keeping in mind that the U.S. equity portfolio is only 24 percent of the total fund.

Ms. Becker-Wold reviewed the definitions of passive and active management and the scope of active management, including absolute and relative risk. Active strategies incorporate absolute and relative return in that the portfolio differs from an index due to the pursuit of excess returns. She reviewed the WSIB's current U.S. equity portfolio structure to that of endowments and the WSIB's asset allocation mix compared to other relevant public plan sponsors

Mr. O'Leary noted that all the quotes in Ms. Calkins presentation related to the Board's 1997 decision to move to 100 percent passive management in the U.S. equity portfolio were still valid today. He reviewed the case for passive management, including the belief in the efficient market hypothesis, and/or that it is difficult to identify and retain managers that have a high probability of outperformance net of fees. He also reviewed the preconditions for active management, including the belief that top performing managers can be identified, retained, and terminated at the appropriate times, that markets are not fully efficient, and that certain indices do not adequately represent the market.

He reviewed the performance of U.S. equity active management, noting that it is difficult to assess due to time period dependency, benchmark misspecification, and database survivorship bias.

[Mr. Nierenberg was in attendance at 2:54 p.m.]

Mr. O'Leary reviewed the returns of the Russell 1000 large cap and small cap indices over different time periods to demonstrate the time period dependency of capitalization. He reviewed the return differential between top performing and low performing public equity managers, noting that the difference was not nearly as great as it is in the private equity arena.

Discussion ensued regarding the demonstrated ability of some managers to consistently outperform, especially in the small capitalization universe; importance of identifying the right managers; ability of plan sponsors to stay the course and even reallocate assets to underperformers in the believe of reversion to the mean; risk profile of the portfolio; attractiveness of approaches such as fundamental indexing; and manager compensation.

Mr. Bruebaker reiterated that staff was looking for any input the Committee had on discussions scheduled for April and May. He indicated that members may provide input now or at any time prior to the meetings. In April, discussion will focus on capitalization, value versus growth, and global investing. In May, discussion will focus on extremely active strategies and, at the Board meeting, on investment beliefs. In June, staff will bring their recommendation regarding the U.S. equity structure to the Public Markets Committee, which will set the stage for an in depth discussion at the July Board retreat regarding the asset/liability study.

OTHER ITEMS

There was no further business to come before the Public Markets Committee and the meeting adjourned at 3:38 p.m.