APPROVED

WASHINGTON STATE INVESTMENT BOARD
Public Markets Committee Meeting Minutes
April 10, 2007

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:	Mason Petit, Acting Chair Charlie Kaminski John Magnuson Robert Nakahara David Nierenberg Judy Schurke
Members Absent:	Dave Scott, Chair Senator Lisa Brown Representative Helen Sommers
Other Board Members Present:	Glenn Gorton George Masten Sandy Matheson
Others Present:	Joe Dear, Executive Director Gary Bruebaker, Chief Investment Officer Theresa Whitmarsh, Chief Operating Officer Liz Mendizabal, Public Affairs Director Nancy Calkins, Senior Investment Officer – Public Equity Bill Kennett, Senior Investment Officer – Fixed Income Diana Will, Senior Investment Officer – Asset Allocation Beth Vandehey, Compliance Director Steve Lerch, Research Director Kristi Bromley, Administrative Assistant – Investments Paul Silver, Assistant Attorney General Janet Becker-Wold, Callan Associates Michael O'Leary, Callan Associates Jack Gray, Grantham, Mayo, Van Otterloo Robert Turner, Turner Investments

[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 Acting Chair Petit identifying members present.

REVIEW AND APPROVAL OF MINUTES – FEBRUARY 6, 2007

Acting Chair Petit announced that, due to a lack of quorum, adoption of the February 6, 2007, Public Markets Committee meeting minutes was deferred to the May 2 Public Markets Committee meeting.

EDUCATION SESSION – U.S. EQUITY STYLE AND CAPITALIZATION STRATEGIES

Mr. Bruebaker introduced himself and reviewed the previous educational sessions related to the U.S. equity program structure. The February session outlined the history of the WSIB's U.S. equity program in the context of the total retirement portfolio, reviewed the impact of the increases to international equity, discussed the pros and cons of active and passive management, and compared the WSIB's asset allocation to other leading investment funds. He stated that the April session would include a review of the current composition of the WSIB's U.S. equity program, examine alternative approaches, and include discussions regarding value, growth, and global investment strategies. He noted that the session would close with a review of a discussion document prepared in an attempt to document investment beliefs and lessons learned from the educational session.

Mr. Bruebaker noted that the May session would be a panel discussion/presentation by Callan, Goldman Sachs, Optima Fund Management, and Hamilton Lane. The topics will include a review of marketable alternative strategies also known as hedge funds, the spectrum of available strategies, key issues surrounding the strategies, the role of the prime broker, relationship of marketable alternatives to private equity, and implementation issues.

Public Equity Structure Overview

Mr. O'Leary introduced himself and reviewed the outline for his presentation. He noted that the February session included a discussion related to asset allocation differences and stated that is clearly the most important decision to make in terms of the effect on performance. He stated the April session was focused on domestic equity in particular in addition to a discussion of how global equity effects portfolio structure. The main things to consider in the active versus passive portfolio structure discussion are investment beliefs and what benchmarks to use. The current structure of the WSIB's U.S. equity portfolio is very broad and primarily passive. The actively managed portion of the portfolio is invested in a tightly risk-controlled manner focused on relative performance.

Mr. O'Leary reviewed the factors affecting structure choice, in particular program size and active versus passive beliefs. One of the major intellectual hurdles confronting large programs such as the WSIB is scale and the ability to find sufficient managers with sufficient capacity that will provide superior results net of investment management fees.

[Ms. Matheson was in attendance at 1:09 p.m.]

Mr. O'Leary stated that, from a consulting perspective, unless an investor has strong philosophical beliefs to the contrary, their portfolio should have characteristics similar to the broad market when the entire portfolio is considered in aggregate. This is true unless the investor is comfortable that some attribute of style or size is going to generate excess returns such that they are able to withstand pronounced periods of underperformance and maintain a long-term investment focus.

Mr. Bruebaker noted the importance of maintaining focus on the entire WSIB retirement portfolio, not just the public equity program in isolation. Intuitively, it seems that the WSIB retirement portfolio has a growth tilt built into its asset allocation framework. The WSIB Research Director is currently with Capital Dynamics in looking at the entire retirement portfolio to quantify any growth or value tilt.

Mr. O'Leary noted that active and passive investing strategies complement each other and are not mutually exclusive. For large funds, he maintained a bias that a significant proportion of the large cap portfolio be passively managed. He also had a strong view that the small cap portion of the portfolio should primarily be actively managed. Ms. Matheson inquired about those two biases and Mr. O'Leary responded that the bottom line is the magnitude of possible outperformance in actively managed small capitalization domestic equity stocks has been much greater than the possible outperformance in the large capitalization sector.

Mr. O'Leary continued his presentation reviewing slides illustrating the performance differences between large and small cap stocks and the cycles of growth and value relative to performance. He reviewed two basic structure archetypes, relative return and absolute return, including differences and similarities and noted that most managers blend the two archetypes.

[Ms. Schurke was in attendance at 1:29 p.m.]

Mr. O'Leary reviewed the WSIB's current U.S. equity program structure, which is invested 75 percent in passive equity and 25 percent in enhanced passive mandates. The current structure is style and capitalization neutral relative to the broad U.S. equity market. He encouraged the Committee to think about investing a larger portion in enhanced and perhaps liberalizing the definition of enhanced. He also urged strong consideration of the feasibility of active small cap management as well as the appeal of global investing.

Discussion ensued regarding the feasibility of investing in small cap for a fund of the WSIB's size, examples of what another public fund has done in this area, and the importance of identifying good managers and investing with them early, as well as diversification among managers. Mr. O'Leary stated that the average small cap manager has actually done better than the index by more than enough to compensate for their fees. Mr. Nierenberg raised the issue of timing in relation to small cap and reversion to the mean. It was noted that the WSIB already has small cap exposure through its passively managed portfolio and active investing in this area could provide better relative return. Discussion continued regarding the ideal number of small cap managers to utilize in a portfolio and the increased level of risk in a relative sense as there would be a much greater possibility that a portion of the portfolio would have variance to the benchmark. Mr. Masten noted that the Board currently takes substantial risk in another area and could increase our likelihood of increasing return by investing more in that area.

[Mr. Nierenberg was no longer in attendance at 1:50 p.m.]

Discussion ensued regarding the importance of manager selection, the importance of refreshing any pool of small cap managers due to the high mortality rate of small cap managers, and the importance of developing and nurturing relationships in this area. Mr. O'Leary stated that he would forward research that Callan Associates has done in this area which suggests that managers that have less in the way of credentials in assets under management and years in business are frequently the most successful. He stated that where a fund takes its active risk is important with the bottom line being that investors should spend their active risk dollars in areas where they can get the most "bang" for their buck, as the WSIB has done in private equity. He noted that private equity investing adds some of the same risks that small cap investing would.

[The Committee recessed at 1:57 p.m. and reconvened at 2:07 p.m.]

Value Investing
Dr. Gray of Grantham, Mayo, Van Otterloo (GMO) introduced himself and reviewed what interests GMO about value investing. As value investors, GMO believes that the reason value persists is that if an investor gets value wrong they don't lose as much so there is some risk control built in. The big risk in investment markets is buying something expensive that goes wrong. He noted that value investors such as GMO view the market and the world differently than growth managers such as Turner Investment Partners, which is part of the reason for diversifying among managers. He reviewed GMO's process for value investing and the belief that markets are fundamentally inefficient and full of human beings that are not always rational. Over the long term, buying stocks cheaper than they should be will lead to outperformance for behavioral reasons.

Dr. Gray reviewed charts depicting the relative outperformance of value in the long term and noted that the more inefficient the market the better. Markets that are more efficient are not as impacted by behavioral factors, but behavior still plays a role. Dr. Gray reviewed the market characteristics that are both favorable and unfavorable to value investing and noted that it is extremely important to have a long-term focus when investing in value.

Discussion took place regarding strategies that are long quality companies and short low, such as a 140/40 strategy. Dr. Gray noted that GMO believes this is the right thing to do, although their hedge fund strategy has not done well over the past 18 months. They believe that the recent growth of small companies that tend to be heavily leveraged and have had their prices pushed up by buying back their stock and by private equity managers taking them over is not sustainable. When the market turns strategies such as theirs will be rewarded.

Mr. Kaminski and Mr. Nierenberg stressed the importance of cultivating relationships with good managers.

Growth Investing
Mr. Turner, Turner Investment Partners, introduced himself and referenced a paper that he distributed regarding how growth and value cycles can enhance results in global stocks. He reviewed the definition of value and growth stocks and stated that the challenge for growth managers is identifying rapidly growing companies and having the discipline to exit at the right

time. He reviewed the global growth and value performance cycles from 1981 to 2007 and discussed factors of the growth markets and market cycles.

[Ms. Schurke was no longer in attendance at 2:47 p.m.]

Mr. Turner reviewed sector comparisons of value and growth investment styles. He also reviewed the effect of the macro economic environment on value and growth performance cycles, noting that delayed and exaggerated monetary actions typically cause economic boom/bust cycles, value stocks typically outperform following a period of monetary easing, and growth stocks typically outperform following periods of monetary tightening.

[Mr. Nierenberg was in attendance at 2:55 p.m.]

Mr. Turner reviewed countries that exhibit value and growth style biases by sector. He noted that value and growth performance cycles are significant and should be exploited; valuations, earnings growth, sector weights, and economic cycle sensitivity differentiate the two investment styles; and lagged effects of global monetary conditions and relative valuations typically determine style outperformance. He noted Turner Investment Partners' belief that style bias may be effectively implemented via region/country overlay.

Discussion ensued regarding active management styles, importance of identifying quality managers and letting them use their professional judgment in making investments, and the importance of the Board determining whether it wants to focus on absolute or relative returns and risk.

Global Investing
Ms. Becker-Wold noted that the world markets are now more correlated and true global investing allows active managers discretion to allocate across regions, countries, sectors, and securities as well as better express their currency view. She reviewed the actual WSIB equity allocations as of December 31, 2006, compared to the MSCI ACWI. The WSIB's allocation split between domestic and international equities, while unusual compared to our peers, consists of "silo" investments and is not a true global strategy.

Ms. Becker-Wold reviewed the correlation between the non-U.S. and U.S. markets and noted the opportunities for returns and diversification from a broader variety of sources. She reviewed regional and country returns. Although sector consideration is now the primary factor for diversification, country selection is still a factor. The highest and lowest performing countries have generally been in emerging markets.

Ms. Becker-Wold reviewed the sector distributions between various indices as well as an example of the expanded opportunity set available in global investing. She reviewed sample portfolios of stocks for U.S. and non-U.S. portfolios and compared them to the opportunity available for a global portfolio, where the focus would be on the greatest opportunities regardless of country. She also reviewed the traditional currency approach where active currency management can capture the dollar appreciation only versus the global currency approach where active currency management could capture both appreciation and depreciation of the dollar.

Ms. Becker-Wold reviewed the performance of U.S., non-U.S., and global managers. Previously, global equity managers have not fully utilized the opportunities available given limitations in their organizational structures. The organizations have evolved over the past 5 years and companies are now quite capable of true global investing.

She reviewed the style spectrum of global investing, from most constrained to unconstrained, and discussed implementation considerations such as style, source of funds, and size of allocation. She also reviewed implementation issues related to global investing, including loss of control over asset allocation, which is in practice largely a non-issue; limited number of vendors; and interpretation of historical track records given that newer products reflect the current trend towards fewer constraints.

Discussion ensued regarding different strategies, relationship building, and manager selection. Mr. Kaminski stated that he would like the WSIB to continually seek out new opportunities and look for situations where, perhaps because a segment of the market is currently out of favor, we could step in, such as the GMO hedge fund strategy referenced by Dr. Gray. Mr. Bruebaker agreed and stated that it makes sense to utilize the Innovation Portfolio to dollar cost average our exposure into areas such as small cap.

Mr. Bruebaker distributed a document to facilitate discussion of the investment beliefs and lessons learned from the educational session. Discussion ensued regarding the importance of manager selection, in addition to asset allocation, in achieving the Fund's statutory mission to maximize returns at a prudent level of risk. Further discussion ensued regarding the use of active management and the importance of identifying great managers, nurturing and growing those managers, and continuing to cultivate relationships. Mr. Kaminski stated that he would like to see the Board managing more toward the opportunity sets available to the Fund. Discussion continued on the role of a global mandate and possible fit in Innovation Portfolio.

[Mr. Silver was no longer in attendance at 3:56 p.m.]

Acting Chair Petit raised the issue of risk measurement and discussion ensued regarding types of risk and what is being done in this area.

[Mr. Nierenberg was no longer in attendance at 4:03 p.m.]

Mr. Dear noted that this was an item the Board would discuss at the July retreat and is a major focus of the organization.

Mr. O'Leary stated that one of the biggest risks that a Board such as the WSIB undertakes is the ability to maintain their investment focus and discipline.

OTHER ITEMS

There was no further business to come before the Public Markets Committee and the meeting adjourned at 4:07 p.m.