APPROVED

WASHINGTON STATE INVESTMENT BOARD
Public Markets Committee Meeting Minutes
May 2, 2007

The Public Markets Committee met in open public session at 1:01 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 David Nierenberg Mason Petit Judy Schurke Representative Helen Sommers
Members Absent:	Robert Nakahara
Other Board Members Present:	Glenn Gorton George Masten
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 David Thatcher, Investment Officer – Public Equity Kristi Bromley, Administrative Assistant – Investments Paul Silver, Assistant Attorney General Janet Becker-Wold, Callan Associates Michael O’Leary, Callan Associates Kent Clark, Goldman Sachs Asset Management Robert Picard, Optima Fund Management Mario Giannini, Hamilton Lane Advisors

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

The meeting convened at 1:01 p.m. with Chair Scott identifying members present.

REVIEW AND APPROVAL OF MINUTES – FEBRUARY 6 AND APRIL 10, 2007

Mr. Petit moved to adopt the February 6 and April 10, 2007, Public Markets Committee minutes. Mr. Scott seconded, and the motion carried unanimously.

EDUCATION SESSION – ACTIVE U.S. EQUITY INVESTING STRATEGIES

Mr. Bruebaker introduced himself and reviewed the previous educational sessions related to the U.S. equity investment 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. The April session reviewed the current composition of the WSIB's U.S. equity program, examined alternative approaches, and included discussions regarding value, growth, and global investment strategies.

Mr. Bruebaker noted that the May session would include an overview of marketable alternatives (also called hedge funds), followed by a panel discussion focused on 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. The panel discussion would be followed by a recommendation from staff.

Overview

[Representative Sommers was in attendance at 1:03 p.m.]

Ms. Becker-Wold, Callan Associates, introduced herself and reviewed what constitutes a hedge fund as well as their structures and characteristics. She reviewed the three broad categories of hedge fund styles: relative value, event driven, and opportunistic and the strategies under each category, ranging from low market exposure (absolute return strategies) to high market exposure (directional strategies). She provided an overview of the three broad categories and a graph depicting the allocations of hedge funds within the main strategies. She reviewed the pros and cons of investing in hedge funds and reviewed a periodic chart depicting the annual returns for various hedge fund indices from 1994 to 2006 in addition to hedge fund performance patterns for the same time period. Discussion ensued regarding the periodic chart, including the importance of diversification, the dispersion between top and bottom performing indices, and the importance of operational due diligence when looking at hedge funds.

Ms. Becker-Wold reviewed where hedge funds belong in a portfolio, including considerations for including them within an existing structure or as a separate asset class. Hedge fund "light" strategies such as 130/30 and global tactical asset allocation were reviewed as well as hedge fund data challenges.

[Senator Brown was in attendance at 1:27 p.m.]

Further discussion ensued regarding the dynamic nature of hedge fund strategies.

Spectrum of Investment Strategies
Mr. Clark, Goldman Sachs Asset Management, introduced himself and stated that an investor must have conviction for active management to invest in hedge funds and noted that hedge funds are the purest way to take advantage of manager skill as the relaxation of constraints allows managers to invest where they have the most conviction. He reviewed the evolution of the hedge fund industry and the four main sectors: relative value, event driven, equity long/short, and tactical trading and reviewed the different strategies composing the four sectors. He defined the hedge fund related terms long, short, and arbitrage and provided examples of each investment strategy. Mr. Clark also provided an overview of hedge fund sectors, which depicted Goldman's risk and return assumptions for the four hedge fund asset sectors.

Key Issues in Marketable Alternative Investing
Mr. Picard, Optima Fund Management, introduced himself and reviewed some key issues related to marketable alternatives, including issues with reliability of data when evaluating hedge fund returns and market context—understanding absolute returns relative to market returns. He reviewed some of the challenges involved with measuring risk in hedge funds compared to traditional assets, noting that the biggest risk of hedge fund investors is becoming complacent; they must constantly look at and understand all areas of risk. He reviewed types of risks including transaction / settlement risk, counterparty / credit risk, organization / personnel / headline risk, liquidity risk, and misappropriation of assets risk.

Mr. Picard reviewed a risk/return scatter plot of hedge fund strategies and noted the importance of a well-diversified, multi-strategy, balanced approach when investing in hedge funds. He also reviewed the importance of selecting the right managers, including issues such as sourcing, due diligence, size of manager, capacity constraints, and portfolio issues. He also reviewed case studies of experiences Optima had when evaluating hedge fund managers, which highlighted the importance of performing thorough and complete due diligence. He also reviewed fee structures and redemption issues involved with hedge fund investing.

[The Committee recessed at 2:25 p.m. and reconvened at 2:40 p.m.]

Role of Prime Broker
Mr. Clark reviewed some of the services that prime brokers provide to hedge funds. This is a key relationship for hedge funds and services provided have evolved from more back office type services to include front office services. He reviewed the mechanics of short selling and the role of the prime broker.

Discussion ensued regarding various shorting strategies and market efficiencies. Mr. Nierenberg noted the flight of talent going to hedge funds as well as the importance of the WSIB considering types of investing that we are not currently utilizing that could get us a good return, such as short selling which is a legitimate investment strategy.

Relationship of Marketable Alternatives to Private Equity
Mr. Giannini, Hamilton Lane Advisors, introduced himself and stated his view that there is convergence between private equity investing and hedge fund investing strategies. He reviewed key similarities between the two, including performance, legal structure, fees, investor protection, and measurement as well as key differences, such as liquidity, preferred return, performance target, incentive fees, clawbacks, return levers, and control aspects. An additional advantage for hedge funds is the lower cost of capital.

Mr. Giannini reviewed reasons why private equity firms are driven toward hedge fund business, which explain why talent is flowing to the hedge fund industry. He addressed manager level convergence with private equity firms branching into hedge fund investing as well as hedge funds into private equity investing. He noted the cultural difference between hedge fund and private equity firms, which is one reason why convergence has been a slow process. He addressed myths and misperceptions about convergence and the impact of convergence on private equity investors as well as private equity supply versus opportunity.

Discussion ensured regarding differences and similarities of fee structures between hedge funds and private equity funds and the migration of talent to hedge fund strategies, particularly from long-only equity managers.

Implementation
Mr. O'Leary, Callan Associates, introduced himself and noted that hedge fund-of-funds investing is another option as well as direct investment in hedge funds. Hedge fund investing is a complex business that requires care in selecting managers. It is critical to conduct operational due diligence and to have the expertise to continually monitor the managers post investment. Investors must determine whether direct investing or fund-of-funds investing is right for them; many institutional investors start with fund-of-funds strategies and migrate to direct investing as their commitment to the strategy grows.

He reviewed options for consideration if the WSIB were to invest in marketable alternatives. It is important to consider the desired objectives from any investment in marketable alternatives and the WSIB Innovation Portfolio provides an opportunity for initial investment in marketable alternatives. The type of hedge fund investment structure utilized depends on the investor's beliefs and risk tolerance.

Mr. O'Leary reviewed the importance of operational due diligence, which is a continuing responsibility, as well as the pros and cons of direct investing versus fund-of-funds investing, with the decision based on factors such as allocation size, experience, and opportunity cost of time and effort. He reviewed various methods of performance evaluation and issues surrounding performance evaluation.

Conclusion
Mr. Bruebaker stated that staff believes that within the Commingled Retirement Trust Fund (CTF) the current structure of the equity portfolio is the best structure. Staff also believes that there are active U.S. equity strategies that warrant exploration and that type of exploration is exactly what was envisioned when the Innovation Portfolio was developed.

The action staff requested the Public Markets Committee consider is for the Committee/Board to anoint the current Index and Enhanced Index strategies for the U.S. public equity program within the CTF and to specifically allow staff to employ active strategies such as small cap, value investing, 130/30 strategies, global equity mandates, and marketable alternatives within the Innovation Portfolio subject to the constraints of the Innovation Portfolio policy.

Mr. Kaminski asked about the staffing implications as strategies such as small cap and marketable alternatives might require a larger staff. Mr. Bruebaker stated that executive management has had a number of discussions regarding the current capabilities of the organization and the organization's future. Current staff could implement strategies such as a global equity mandate as it involves the same type of hiring and monitoring of equity managers as we currently undertake.

Mr. Nierenberg stated his support for placing marketable alternatives and other investment strategies in the Innovation Portfolio to gain exposure and cultivate relationships. In addition, it is imperative that the Board be careful and deliberate as the domestic equity and small cap rallies are long-in-the-tooth as is the popularity of hedge funds.

Mr. Masten asked for clarification of the Innovation Portfolio parameters and Mr. Bruebaker responded that no more than 5 percent of the entire CTF could be invested in the Innovation Portfolio with no more than 1 percent of the CTF invested in any one strategy within the Innovation Portfolio. Additionally, every investment in the Innovation Portfolio must be supported and signed by a Senior Investment Officer, the Chief Investment Officer, and the Executive Director. Staff reports these investments to the Board monthly and provides a performance review every quarter.

Mr. Masten also clarified that investments in the Innovation Portfolio would not stand in the way of any decision the Board makes relative to the CTF's allocation to private equity. He stated that the Innovation Portfolio did provide a good way to explore other opportunities.

Mr. Magnuson provided his support for pursuing other strategies in the Innovation Portfolio, noting that it was a good venue for taking an investment step that will serve the Board's beneficiaries well.

Mr. Kaminski agreed and provided his strong support for the Board to continue to seek relationships with good managers. He encouraged applying the lessons learned from the Board's private equity and real estate investing to other areas.

> **Senator Brown moved that the Public Markets Committee recommends that the Board make no change to the current structure of the U.S. equity portfolio within the commingled retirement trust fund and that any actively managed equity strategies beyond current strategies be introduced through the Innovation Portfolio. Examples include actively managed strategies with a bias toward style (e.g., value) or capitalization (e.g., small cap), global equity mandates, marketable alternatives, and other strategies that move toward less constrained portfolio. Representative Sommers seconded the motion.**

Senator Brown noted her appreciation for the educational sessions and stated that she looked forward to utilizing the Innovation Portfolio for these types of investment opportunities.

The motion carried unanimously.

Mr. Bruebaker noted that revisions to the Public Markets Equity - Retirement Funds policy would be brought to the May Board in anticipation of approval of the Committee's recommendation. A copy of the Innovation Portfolio policy would also be provided for the Board's reference.

OTHER ITEMS

There was no further business to come before the Public Markets Committee and the meeting adjourned at 4:03 p.m.