APPROVED

WASHINGTON STATE INVESTMENT BOARD
Public Markets Committee Meeting Minutes
April 1, 2008

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:	George Masten, Chair Charlie Kaminski (via conference call) John Magnuson Robert Nakahara (via conference call) David Nierenberg (via conference call) Mason Petit Mike Ragan Judy Schurke Representative Helen Sommers
Others Present:	Joe Dear, Executive Director Gary Bruebaker, Chief Investment Officer Philip Paroian, Senior Investment Officer – Public Equity Bill Kennett, Senior Investment Officer – Fixed Income Diana Will, Senior Investment Officer – Asset Allocation David Thatcher, Investment Officer – Public Equity Kristi Bromley, Administrative Assistant – Investments Brian Buchholz, Assistant Attorney General

[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 Chair Masten identifying members present.

REVIEW AND APPROVAL OF MINUTES – FEBRUARY 5, 2008

Mr. Petit moved to adopt the February 5, 2008, Public Markets Committee minutes. Mr. Ragan seconded, and the motion carried unanimously.

U.S. ENHANCED INDEXING REVIEW

Mr. Bruebaker introduced himself and noted the three basic options before the Committee: (1) continue the enhanced U.S. equity investment strategy; (2) discontinue the enhanced U.S. equity investment strategy by phasing it out over 3 to 5 years; or (3) discontinue the enhanced U.S. equity investment strategy immediately and develop a transition plan for the assets. He reviewed the investment performance of the three U.S. enhanced indexing managers since inception, 27 months ago. Both Barclays Global Investors (BGI) and State Street Global Advisors (SSgA) have underperformed within reasonable expected ranges given the agreed upon risk tolerances. BGI underperformed by 147 basis points (bps) net, a 1.5 standard deviation event, and SSgA underperformed by 81 bps net, a 0.5 standard deviation. WAMCO underperformed by 880 bps net, which is an 11 standard deviation event.

Mr. Bruebaker reviewed his conflicting views that every dollar the fund earns makes a difference versus the need to focus on the most valuable opportunities (e.g., an added $1 when we could have added $2 elsewhere with the same resources). He noted that the questions addressed in a 1992 article titled "Are Quants' Glory Days Numbered?" are asked every time quantitative investment strategies, such as our enhanced U.S. equity strategies, underperform. Since that 1992 article suggesting that quants' future performance might be challenging, there have only been 2 years when quantitative strategies underperformed: 1998 and 2007.

Mr. Bruebaker stressed the importance of a well-reasoned decision relative to the U.S. enhanced investment strategy based on the belief of whether or not the strategy can provide net value added on a risk adjusted basis over the long term.

[Representative Sommers was in attendance at 1:10 p.m.]

Mr. Paroian introduced himself and provided an overview of his presentation. The Committee's review of the current mix of managers would be conducted in executive session. Mr. Paroian introduced tracking error and information ratio, and the roles they play in evaluating risk in a portfolio. Tracking error, the expected difference from the benchmark, partly answers the questions "How much risk is being taken?" and "How bad can it get?" and is measured as standard deviations. Information ratio, which is extra return delivered divided by risk taken, addresses the question "Is the return worth the risk?"

[Mr. Kaminski was in attendance at 1:15 p.m.]

Discussion ensued regarding portfolio monitoring, discipline of sticking with portfolio guidelines, and benchmarks.

Mr. Paroian stated that, while passive investing is the cornerstone of the WSIB's U.S. equity portfolio, there may be some inefficiency within passive investing. Some of the drawbacks include membership effects; capitalization weighting that may not be optimal; trades not based on fundamental information; inefficient deployment of capital; and increased correlation of stocks in the index without any fundamental basis. The U.S. equity return environment from the 1980s to the early 2000s provided double digit returns and using a passive investment strategy to collect those returns at very low cost made sense. However, if a lower return environment going forward is likely, then adding marginal value is important. Extra cost and effort may be required to meet return expectations and have sufficient funds to pay the promised benefits.

Mr. Paroian noted two ways to look at investment strategies—theory and practical observation. In other words, what should work and what has worked. Enhanced indexing has been proven to work both theoretically and practically. There is an inherent trade-off between risk and return as managers attempt to outperform an index. The diversification, symmetric bets, and risk controls of enhanced indexing managers result in more optimal risk/return trade-offs with higher information ratios than traditional active managers.

Discussion ensued regarding the ability to identify enhanced managers that have higher information ratios and, therefore, generate more return for the risk taken.

Mr. Paroian reviewed quantitative investment strategies, noting that both quantitative and fundamental investment strategies have their place in a diversified portfolio. A recent study conducted by JP Morgan suggests that quantitative strategies tend to have better risk/return ratios and tend to do better in down markets.

Mr. Paroian reviewed the 2007 market environment where fundamental factors did not perform as expected and returns were very concentrated. During the Committee's interview of the current U.S. equity enhanced managers before they were hired in 2005, the managers were explicitly asked what markets would be most difficult for them. The response was that they would have problems in markets where fundamentals were ignored and returns were concentrated—exactly what happened in 2007. That type of market, where momentum was the only thing that mattered and fundamentals like valuation worked against managers, had been unprecedented in the last 10 years.

Staff does not believe that the market place has changed permanently. Staff believes that human behavioral biases have not been arbitraged away and that highly, though not perfectly, efficient markets cannot ignore fundamentals indefinitely. It is important to have commitment to our investment beliefs. Funds that continually change their strategies based on the most recent market conditions are not as successful as those that set a prudent long-term course and stick with it.

Chair Masten announced that the Committee would go into executive session to discuss financial and commercial information relating to investments since public knowledge regarding the discussion would result in loss to the funds managed by the Board or would result in private loss to the providers of the information. The executive session was expected to last approximately 30 minutes at which time the Committee would reconvene in open session.

[The executive session convened at 1:48 p.m. and the Committee reconvened in open public session at 2:36 p.m.]

The Committee discussed the optimal mix of managers in an enhanced index program.

> **Ms. Schurke moved that the Public Markets Committee recommend the Board maintain the enhanced index program and that the specific actions discussed during the executive session be instituted. Further, that the Committee recommend the Board direct staff to conduct a search to build a more optimal enhanced index program. Mr. Ragan seconded the motion.**

Chair Masten stated that he would vote against the motion. He believes that the fund's active risk should be taken in private equity and real estate.

Discussion ensued regarding U.S. enhanced indexing, including risks and optimal manager mix.

> **The motion carried with Chair Masten voting no.**

OTHER ITEMS

There was no further business to come before the Public Markets Committee and the meeting adjourned at 2:46 p.m.