APPROVED

WASHINGTON STATE INVESTMENT BOARD
Public Markets Committee Meeting Minutes
December 1, 2009

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:	Mike Ragan, Chair Charlie Kaminski John Magnuson George Masten Robert Nakahara David Nierenberg (via teleconference) Judi Owens Mason Petit (via teleconference) Judy Schurke
Others Present:	Theresa Whitmarsh, Executive Director Gary Bruebaker, Chief Investment Officer Philip Paroian, Senior Investment Officer – Public Equity Bill Kennett, Senior Investment Officer – Fixed Income Kristi Bromley, Administrative Assistant – Investments Steve Dietrich, 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 with Chair Ragan identifying members present.

REVIEW AND APPROVAL OF MINUTES – JUNE 2, 2009

Mr. Masten moved to adopt the June 2, 2009, Public Markets Committee minutes. Mr. Petit seconded, and the motion carried unanimously.

PUBLIC EQUITY 2010 ANNUAL PLAN

Mr. Paroian introduced himself and the new Assistant Senior Investment Officer for Public Equity, Allyson Tucker.

[Mr. Kaminski was in attendance at 1:04 p.m.]

Mr. Paroian reviewed the structure of his presentation and began by highlighting some of the Board's key investment beliefs for the Commingled Trust Fund (CTF) and additional beliefs related to investing. He reviewed public equity initiatives from the six-year WSIB strategic plan, additional considerations for the public equity program, and keys to success.

Mr. Paroian began the review of his white paper with a discussion of market efficiency noting that markets are highly efficient, but not perfectly so, are subject to bubbles and crashes, and that the degree of efficiency may vary over time. He discussed data relative to the performance of U.S., non-U.S., and emerging markets active managers illustrating active manager performance in periods of market rationality and irrationality. Mr. Paroian stated that, as discussed in the paper, it is imperative to concentrate on managers that we think are truly exceptional; passive management should be the default investment strategy in cases when staff cannot identify exceptional managers. Discussion ensued regarding this approach and Mr. Bruebaker stated that the Board has set a clear direction that they are not interested in managing active U.S. equities; consequently, staff would not bring forth any active purely US focused products. Staff would look for active international or global managers who meet our standards with passive management being the default when such managers cannot be identified. Mr. Nierenberg stated his agreement and stressed the importance of having adequate resources to find the best active managers and then oversee those managers. If we do not have the resources to do this, then we must fall back to more indexing and selection and oversight of fewer active managers.
Mr. Paroian stated that having fewer managers that we believe are exceptional is very important, as is managing to our resources. Having relationships with the very best managers is becoming increasingly important in the public equity arena.

Mr. Paroian reviewed data related to whether global equity strategies can do better than separate U.S. and non-U.S. investment strategies. The data indicates that active management has best success when managers have the scope to find the best investments globally. Some reasons for this are that companies, markets, and research are global; distinctions between U.S. and non-U.S. companies are becoming arbitrary; and the global market is a broader, less efficient universe with more room to add value. He reviewed holdings of a sample global portfolio, the WSIB fixed income credit portfolio, and examples of the behavior of two separate markets and how those markets behave when combined. He reviewed issues with global equity strategies, notably the larger universe of investments to cover and the relative importance of the U.S. and emerging markets weighting.

Mr. Paroian reviewed a graph showing the effect of globalization on emerging markets and noted that the chart was a good depiction of why staff believes that emerging markets will be the driver of performance going forward. Mr. Nierenberg stated there may be a related asset allocation decision regarding emerging markets across the entire CTF portfolio and positive benefits from emerging markets growth in meeting the needs of the beneficiaries.

Mr. Paroian reviewed research into long/short strategies, also known as hedge funds. Managers with talent and skill exist in this area but due diligence is extremely challenging. In addition, in terms of fit within a public equity program, less than 50 percent of hedge fund structures are public-equity based. Most importantly, significant challenges exist such as liquidity and transparency. The Board has a high allocation to private markets and public equity investments in the CTF and therefore a corresponding need to maintain liquidity. Mr. Magnuson asked, of the other pension funds Mr. Paroian has met, how many had absolute return strategies and were those strategies in a separate allocation. Mr. Paroian responded that most funds did employ long/short strategies and did so through a separate allocation, not within the public equity program. Some funds invested directly and some through fund of hedge fund strategies. Mr. Bruebaker also noted concern with fee structure of hedge funds.

Mr. Paroian reviewed downside protection strategies, noting that the research so far is discouraging. He also reviewed the desired characteristics and return dispersion for downside protection managers. Traditional options such as hedging strategies are expensive, and hedge funds and value managers have not protected on the downside as effectively in recent periods. Discussion ensued regarding the importance of downside protection in meeting the WSIB's actuarial returns in order to meet the needs of the beneficiaries. The Committee was broadly supportive of the idea that downside protection and risk management was valuable, even if it meant sacrificing some upside return.

Mr. Paroian reviewed governance and implementation issues for the WSIB public equity program, noting that all public equity strategies are governed by the state's personal services contract procurement requirements. Due to both the Fund's size and governance structure, hiring managers is not a fast process. He reviewed the program's capacity for overseeing assets under management and reviewed commingled fund investments versus separate account investments, noting that separate account investments provide the WSIB with complete transparency, full liquidity, and control over securities lending and cash collateral pools through the custodian bank.

Mr. Paroian reviewed discussion points related to benchmarks, including the criteria for benchmarks and benchmark providers. WSIB investment staff will continue to research the appropriate benchmark for the public equity program. He reviewed passive management, which is an important part of the public equity program as it delivers broad market exposure at little cost with lower tracking error. Searches for U.S. and non-U.S. passive managers were conducted in 2007 and 2009 and, due to the Fund's size, BGI and SSgA remain the only two managers that met the minimal requirements. Public equity staff recommend that WSIB migrate toward separate accounts in the CTF, which is partially mitigate concerns with WSIB's passive providers.

Chair Ragan announced that the Committee would now consider the fixed income policy revisions and then return to the public equity annual plan.

[Mr. Nierenberg was no longer in attendance at 2:25 p.m.]

<u>FIXED INCOME POLICY REVISIONS</u>
FIXED INCOME RETIREMENT FUNDS POLICY 2.10.200
LABOR AND INDUSTRIES' INSURANCE FUNDS POLICY 2.20.100

Mr. Kennett introduced himself and stated staff recommends revisions to both the Retirement Funds policy and Labor and Industries (L&I) policy. The rationale for the revisions is that staff desires to prevent the forced sale of mortgage-backed, asset-backed, and commercial mortgage-backed securities that fall below investment grade in both the Retirement and L&I funds. In addition, staff would like to eliminate the minimum duration requirement for the Supplemental Pension Fund and lower the maximum duration from 2.25 to 2.00. During the crisis, only one security fell below investment grade and staff was forced to sell that security, although they would have preferred to hold on to the security. Discussion ensued regarding the losses experienced by other investors resulting from forced sales and the attractive purchase opportunities that are available at such times to investors that are able to hold below investment grade securities. Mr. Kennett noted that Standard and Poor's had downgraded a number of commercial mortgage-backed securities only to raise the ratings of those securities only two days later, resulting in large losses to those that were required to sell the securities when they were downgraded.

Ms. Schurke stated that Mr. Kennett had reviewed the proposed policy changes with L&I during the last portfolio review meeting. She expressed her support for the policy revisions.

> **Mr. Masten moved that the Public Markets Committee recommend the Board approve the proposed revisions to the Fixed Income Retirement Funds Policy 2.10.200. Ms. Owens seconded, and the motion carried unanimously.**

> **Mr. Masten moved that the Public Markets Committee recommend the Board approve the proposed revisions to the Labor and Industries' Insurance Funds Policy 2.20.100. Ms. Schurke seconded, and the motion carried unanimously.**

[The Committee recessed at 2:33 p.m. and reconvened at 2:40 p.m.]

<u>PUBLIC EQUITY 2010 ANNUAL PLAN - CONTINUED</u>
Mr. Paroian reviewed the evolution of the public equity program in the CTF as well as the CTF's asset allocation. The Board has a significant allocation to private markets in the belief that the private markets generate higher returns than public markets. This decision affects the allocation of the CTF's risk and return budget as well as the capacity for illiquidity. Mr. Paroian reviewed the implications of that decision on the role of public equity within the CTF. Given the WSIB's governance structure and resources, it makes sense to focus efforts on less efficient spaces (global and emerging markets) and broad mandates and migrate towards a broader, more flexible, more focused, global structure. He discussed the proposed strategy for global manager searches in 2010. Mr. Bruebaker stressed that staff will focus on finding the best managers, those in whom we have high conviction--not just the best manager we could find in a particular active strategy.

Mr. Paroian reviewed public equity in other funds such as L&I, Guaranteed Education Tuition program, Developmental Disabilities Endowment Fund, and the Common School Fund, as well the defined contribution programs. He stated that a comprehensive review of the defined contribution options in the Plan 3 Retirement Funds and the Deferred Compensation Program would be conducted in 2010, with public equity staff working with asset allocation staff, the Department of Retirement Services, and the Employee Retirement Benefits Board.

Mr. Paroian reviewed the public equity program's 2009 accomplishments, including termination of some underperforming managers, non-U.S. passive search, benchmark analysis, competitive searches for enhanced index and emerging markets managers, recruitment of the assistant senior investment officer, completion of this comprehensive review of the public equity program, and implementation of a new target date retirement strategy fund.

Mr. Paroian reviewed initiatives for 2010 and beyond, which include improving manager analytics and risk management, continuing to review and research benchmarks, migrating to separate accounts in the CTF; conducting the global manager search(es), conducting a review of the defined contribution options, and planning for a possible transition manager pool procurement in 2011. Staff will also continue to research areas such as sector weights, capitalization size analysis, frontier markets, and methods of improving the return distribution from equity.

[Ms. Schurke was no longer in attendance at 3:06 p.m.]

Discussion ensued on the migration to global active management as well as such topics as benchmarks, currency management, and commodities.

> **Mr. Masten moved that the Public Markets Committee recommend the Board adopt the 2010 Public Equity Annual Plan. Ms. Owens seconded, and the motion carried unanimously.**

ENHANCED INDEX EQUITY MANAGER SEARCH RESULTS

Mr. Paroian reviewed the recent history of the enhanced index program and summarized the process used for the enhanced indexing search. The search was conducted from June 1, 2009 through November 30, 2009, with onsite visits to four finalists conducted from mid-September through early October 2009. Staff continue to believe enhanced indexing is a viable strategy; however, none of the four finalist firms (with one exception) generated strong support and high conviction from the evaluators. He reviewed the pros and cons of each of the four finalists. Mr. Paroian reviewed the decision making process and internal discussions between the evaluators and the Chief Investment Officer on whether it was worth continuing the enhanced index program with just one manager, DE Shaw. It was unanimously felt that this was not optimal. However, staff will be asking DE Shaw to bid in the active searches conducted in 2010 though staff has also stressed to DE Shaw that 2010 procurements will be conducted in an open and fair manner with no preconceived conclusions. Discussion ensued regarding DE Shaw's strategy and optimal risk level, and the enhanced indexing recommendation.

> **Ms. Owens moved that the Public Markets Committee recommend the Board approve the discontinuance of the enhanced index program and further direct staff to transition the U.S. enhanced index assets currently managed by BGI into the U.S. passive index, also managed by BGI, and to transition the non-U.S. enhanced index account currently managed by BGI into the non-U.S. passive index which is managed by SSgA. Mr. Masten seconded, and the motion carried unanimously.**

OTHER ITEMS

There was no further business to come before the Public Markets Committee and the meeting adjourned at 3:21 p.m.