WASHINGTON STATE INVESTMENT BOARD
Public Markets Committee Meeting Minutes
December 6, 2011

The Public Markets Committee met in open public session at 1:02 p.m. on December 6, 2011, at the Washington State Investment Board (WSIB) office at 2100 Evergreen Park Drive Southwest, Olympia, Washington.

Members Present:	Mike Ragan, Acting Chair Bill Longbrake George Masten Robert Nakahara (teleconference) David Nierenberg (teleconference) Natasha Pranger Judy Schurke
Members Absent:	Judi Owens
Other Board Members Present:	Treasurer McIntire (teleconference)
Others Present:	Theresa Whitmarsh, Executive Director Gary Bruebaker, Chief Investment Officer Bill Kennett, Senior Investment Officer – Fixed Income Maria Tosteson Rosen, Assistant Senior Investment Officer – Fixed Income Phil Paroian, Senior Investment Officer – Public Equity Allyson Tucker, Assistant Senior Investment Officer – Public Equity David Thatcher, Investment Officer – Public Equity 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 Acting Chair Ragan identifying members present.

<u>REVIEW AND APPROVAL OF MINUTES – MAY 3, 2011</u>

> **Mr. Masten moved to adopt the May 3, 2011, Public Markets Committee minutes. Ms. Pranger seconded, and the motion carried unanimously.**

SAVINGS POOL POLICY 2.13.200 REVISION

Mr. Kennett introduced himself and noted that Mr. Hill, Director of the Department of Retirement Systems, had requested that additional information regarding the Savings Pool option within the Deferred Compensation Program (DCP) be provided to the Committee. Mr. Bruebaker noted that the information shows the significance of the Savings Pool within the DCP. The assets in the Savings Pool increased as a percentage of the DCP between September 2007 and March 2009 as participants allocated resources to the Savings Pool and the value of equities within the DCP declined. The quarterly ending balances from March 2001 to September 2011 show an increase of 157 percent within the Savings Pool; the DCP increased by 94 percent during that period. Over time, the yield on the Savings Pool has decreased due to the lower interest rate environment and the effect of larger amounts of cash within the program. The number of insurance companies from which the WSIB can purchase Guaranteed Investment Contracts (GICs) has decreased which has resulted in more cash being held in the program.

Ms. Tosteson Rosen introduced herself and stated that the Savings Pool, which is an investment option for DCP and Judicial Retirement Account participants, is comprised of GICs issued by insurance companies and cash, which staff invests in a money market fund. Currently only two insurance companies meet the credit rating criteria specified within the Savings Pool Investment Policy of Aa3 or better by Moody's Investors Service. As a result, cash has increased to approximately 45 percent of the Savings Pool's assets. Staff has continued to monitor this situation as ratings of insurance companies have decreased and identified four options that would allow the GIC portion of the portfolio to increase. However, staff does not believe that any of the options are viable. The first option would be to go down in credit rating from a minimum of Aa3 to a minimum of A3. Staff does not believe this would be in the best interest of participants as the primary objective for the fund is to ensure the preservation of principal. The second option would be to increase the amount held by one provider from 15 percent to 20 percent. This option would allow staff to invest marginally more with the two providers that meet the policy's credit rating criteria. However, it exposes the fund to additional counterparty and concentration risks. The final two options are provider managed accounts and synthetic GICs. Neither option is considered viable as the fund would continue to experience credit rating constraints and increased counterparty and concentration risk. Additionally, both the managed account and most synthetic GICs are issued as evergreen contracts with a pro rata benefit payout provision as opposed to the required Last In, First Out (LIFO) benefit payout provision. Consequently, these contracts could not be written unless all existing contracts were revised which would entail agreement of all current GIC providers.

Staff continues to believe the best option for the Savings Pool is to invest the maximum allowed under policy with the insurance companies rated Aa3 or better and invest the remaining cash in a money market fund. When markets normalize, and if other provider ratings improve to Aa3 or better, staff will move out of cash into GICs. Language has been added to the Savings Pool Investment Policy's portfolio management section addressing this issue.

Mr. Kennett stressed the primary investment objective of the fund is safety of principle. In addition, we are still in the midst of a financial crises and staff does not believe that it is appropriate to go down in credit quality. Mr. Kennett reviewed the proposed market considerations language.

Mr. Bruebaker said WSIB staff has had conversations with Mr. Hill and his staff at DRS whom are supportive of these changes. He noted that Ms. Frost, Deputy Director of DRS, was in the audience if the Committee members had any questions for her.

Discussion ensued regarding other types of investments that might meet the goals of the savings pool, including the CDARS program, or other commingled types of programs with insured deposit accounts that offer principle protection. Mr. Longbrake suggested that staff talk with the Treasurer's office as some of the funds the Office of the Treasurer manages are in CDARS. Treasurer McIntire noted that Mr. Extine would be a resource for staff on this issue.

Mr. Masten noted that when the Savings Pool was established there was competition between insurance providers and banks, which resulted in much higher rates.

Treasurer McIntire inquired on the management fees of the underlying mutual funds within the money market fund; Mr. Bruebaker stated that staff would provide this information to the Treasurer.

Acting Chair Ragan stated that he is usually uncomfortable talking about a specific timeframe in a policy document and noted the revision to the policy focuses on the current financial crises rather than a general situation. The Committee revised the proposed policy revision language to remove the time specific reference to the global financial crises.

> **Mr. Masten moved that the Public Markets Committee recommend the Board approve the proposed revisions as amended to the Savings Pool Policy 2.13.200. Ms. Schurke seconded, and the motion carried unanimously.**

<u>SECURITIES LENDING PROVIDER</u>

Mr. Thatcher introduced himself and noted that a Request for Proposals for Global Custodian and Securities Lending Services was issued in June 2011. Staff 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 December Board meeting. The selection process will yield one bank for both services. Two contracts will be 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. Staff requests that the Public Markets Committee defer the award of the securities lending provider to the December Board meeting.

Mr. Bruebaker noted that this request is consistent with past practice.

> **Ms. Pranger moved that the Public Markets Committee defer award of the securities lending provider to the December 15, 2011, Board meeting. Mr. Masten seconded, and the motion carried unanimously.**

PUBLIC EQUITY GLOBAL BENCHMARK RECOMMENDATION AND POLICY CHANGES

Ms. Tucker introduced herself and noted that the Committee members had received a research paper in advance of this meeting that describes the comprehensive benchmark review in detail. These materials also included revisions to seven policies: five resulting from the benchmark recommendation and two reflecting the new defined contribution menu implemented in October. Since the last benchmark review in 2007, the benchmark landscape has changed considerably. The restructure of the equity program in 2011 towards active global equity management also made this review timely. The review results in a recommendation to change the public equity policy benchmark to the MSCI All Country World Investable Market Index (ACWI IMI) and to adopt the MSCI family of indices at the mandate level and for as many accounts as possible. Ms. Tucker noted that when the Board adopted the global equity benchmark in 2007, it did so in order to maintain a global perspective in the portfolio. The benchmark was intended to reflect the changing global weights over time. By changing to the MSCI ACWI IMI, the WSIB will not lose this focus. The Board will maintain its global perspective and also benefit from a more efficient, consistent, and simple structure.

The review consisted of five benchmarks evaluated against seven widely accepted criteria for evaluating benchmarks: investability; completeness; clear, published rules and open governance structure; accurate and complete data; acceptance by investors; availability of crossing opportunities, derivatives, and other tradable products; and low turnover and related costs. Additional factors for the review included performance and risk characteristics; coverage versus investability; and country classification schemes. Because of the WSIB's size and because all indices met minimum criteria, the review focused on the top two criteria—investability versus coverage.

Ms. Tucker reviewed performance and risk characteristics of the indices. She noted that the reason U.S. equity statistics were presented separately is that the passive equity accounts are typically split into U.S. and non-U.S. mandates rather than global mandates. Under staff's proposal, the passive accounts currently managed against the Dow Jones U.S. Total Stock Market Index would migrate to the MSCI U.S. IMI mandate.

Ms. Tucker reviewed the coverage versus investability tradeoff. Theoretically, the most complete benchmark is the one that includes the most securities or has the highest coverage. However, no global equity benchmark provider captures the entire universe. They each use benchmark construction methodology to determine the "investable universe." The benchmark providers use investability as the constraint, and each defines investability differently. She reviewed a spectrum between more coverage and more investability to illustrate where the various benchmarks stand in comparison to one another, based on staff's research. The recommended benchmark, MSCI ACWI IMI, falls at the more investable part of the spectrum.

Ms. Tucker reviewed key points related to float calculations. Market capitalization is the aggregate value of a company's equity shares outstanding and includes all share classes, even those not accessible to investors like the WSIB. Free float market capitalization is the part of the market cap that is investable for the WSIB. Each provider uses a different methodology for determining how to calculate the size of the free float. The types of things that would restrict free float would be large government holdings, founders' shares, and foreign ownership restrictions, which results in shares that are not in the public domain for the WSIB to purchase. In staff's view, these should not be included in the investable market cap calculation. More conservative float adjustments are preferable because they come closer to representing investments the WSIB can actually make in the markets. Because of the large size of the WSIB public equity portfolio, investability is crucial. Staff's research indicates that MSCI employs a more conservative float methodology.

Country classification schemes were also discussed as not all countries are classified the same among providers. Generally, the differences have to do with whether the index provider emphasizes economic development or capital market development. Classification of South Korea and Taiwan are the largest differences among providers because they are such large markets. Both countries have economies that are developed, but there are still critical attributes common to all developed country stock markets that these two countries do not have. Those have to do with currency convertability and ability to transfer shares. These are big issues for investors and in staff's opinion, valid reasons for maintaining emerging markets status until resolved. It is worth noting that all of our emerging markets managers treat South Korea and Taiwan as part of their investable universes. Other differences include whether the criteria for evaluating countries is done on a proprietary basis or whether the assessments are outsourced to third parties.

Staff polled all the existing managers and asked which indices they support. MSCI was fully supported by all of the managers and most of the strategies in which the public equity portfolio is invested use MSCI benchmarks as the managers' chosen benchmark. Increased acceptance by investors means more assets under management. This leads to increased crossing opportunities. Staff utilizes crossing opportunities during transitions of assets. Crossing stock purchase and sales means cost savings for members since the equity managers can transact without going to the market, which means saving on transaction costs and negative market impact.

Ms. Tucker reviewed implementation issues if the benchmark changes are approved by the Board. Benchmarks are published in two versions – a gross version, which does not include tax effects, and a net version, which does include tax effects. The

Commingled Trust Fund (CTF) is not subject to taxation on income in the U.S., but is subject to certain foreign tax regimes. For this reason, staff uses gross versions of the benchmark in the U.S. and the net version for non-U.S. markets. The global equity benchmark is problematic from a gross versus net perspective because it includes both U.S. returns, which we prefer to see gross of tax effects, and non-U.S. returns, which we prefer to see net. The gross return modestly overstates performance and the net return understates it. MSCI publishes a gross U.S. and net non-U.S. benchmark, which is the most appropriate benchmark version for the WSIB. Because it is the most appropriate, if this change is approved, staff will retroactively restate performance going back to adoption of the global benchmark in 2007. The since inception return difference between MSCI and Dow Jones is 13 basis points lower. This means the relative performance of the public equity portfolio will be slightly higher.

In response to a question from Treasurer McIntire, Ms. Tucker clarified that the MSCI benchmark is a stand-alone company and no longer associated with Morgan Stanley.

Mr. Masten moved that the Public Markets Committee recommend the Board adopt the MSCI ACWI IMI for the public equity policy benchmark and approve the proposed revisions to the following policies:

- **2.10.100 Public Markets Equity – Retirement Funds**
- **2.11.100 Defined Contribution Plan 3 Retirement Funds**
- **2.13.100 Deferred Compensation Program and Judicial Retirement Account**
- **2.20.100 Labor and Industries' Funds**
- **2.25.100 Permanent Funds**
- **2.35.100 Advanced College Tuition Payment Program**
- **2.35.400 Developmental Disabilities Endowment Trust Fund**

Ms. Pranger seconded, and the motion carried unanimously.

2012 PUBLIC EQUITY ANNUAL PLAN

Mr. Paroian introduced himself and the public equity team. He reviewed some of the Board's investment beliefs for the CTF and additional equity-related investment beliefs. These included the mission of maximizing returns at a prudent level of risk; long-term time horizon; criteria for active management; and the importance of diversification, risk management, and global focus. Mr. Paroian noted the importance of maintaining liquidity in the WSIB's public equity investments given the Board's 43 percent allocation to illiquid investments as well as the importance of transparency. Keys to success for the public equity program are to maintain a long-term perspective, develop an efficient and effective program structure, and select managers that will add value over the long term.

Mr. Paroian reviewed key concepts including globalization and growth of emerging markets. He provided examples of how the emerging markets story is viewed differently by various investors. He addressed options for downside protection and discussion ensued regarding ways to constrain the tails of return distribution.

Mr. Paroian reviewed governance and implementation issues specific to management of the public equity portfolio within the WSIB. In terms of capacity, focus in an advantage. The WSIB's public equity program oversees over $28 billion in 67 accounts with 17 managers. The governance process for public equity manager searches was re-examined this year. The Office of Financial Management (OFM) approved an expanded exception to the standard state contracting process for public equity manager searches based on the open and competitive process utilized by staff and the Board in selecting equity managers. Key points which are critical to this process are that the public equity annual plan is discussed and approved in a public meeting; the WSIB advertises potential public equity investment mandates under consideration; and all interested candidates have the opportunity to participate by ensuring their firm's information is included in the public database utilized by public equity staff for screening potential managers (currently, eVestment Alliance). Selection of managers will continue to be decided at open public meetings of the Public Markets Committee and the full Board. This expanded exception will allow staff greater flexibility to identify and recommend firms to the Public Markets Committee and Board for hire when appropriate to do so.

[The Committee recessed at 2:22 p.m. and reconvened at 2:37 p.m.]

Mr. Paroian noted that public equity is the largest asset class in the CTF and can have high volatility and exposure to macro-political risk. However, public equity has the lowest liquidity risk and lowest "active risk" of all the Board's asset classes. The Board's focus has been to obtain broad, inexpensive exposure to public equity. Given the illiquidity of the private markets and the CTF's high allocation to them, the public equity allocation must remain liquid, which has precluded investments in certain strategies. Consistent with the framework of the WSIB investment beliefs, the public equity portfolio takes limited active management risks to reach for higher returns as that is the role of the private market portfolios. Prudent active management may be used where the WSIB can identify and hire managers that will outperform on a long-term risk-adjusted basis. Given the WSIB's governance structure and resources, it is best to focus efforts on less efficient markets and opportunities; maintain broad mandates; focus on the portfolio as a whole; and concentrate on global equity and emerging markets.

Mr. Paroian reviewed the 2011 initiatives and accomplishments. The two most significant were the completion of the non-U.S./global search for the CTF and the improved menu design for the defined contribution programs. He reviewed changes to the public equity program since he was hired in 2008, which included 9 comprehensive structural reviews and 12 competitive searches as well as increased and enhanced due diligence and monitoring of managers. He reviewed the effect of the changes since 2008 on the public equity mandates and investment strategies employed in the CTF as well as the revised and simplified menu implementation for the defined contribution plans. He also reviewed the current profile of the public equity program within the CTF in terms of risk and capitalization, sector, and country weightings.

Mr. Paroian noted that public equity staff has brainstormed for the past several months and developed eight major themes for potential future research. He led the Committee through a discussion of the eight themes, including the pros and cons of each as well resource requirements. The themes discussed were: (1) Continue to enhance manager monitoring; (2) Continued enhancement to Plan 3/DCP/JRA; (3) Comprehensive review of passive; (4) Research active volatility management through hedging strategies; (5) Research hedge fund strategies; (6) Continued research into emerging and frontier markets; (7) Comprehensive review of small- and micro-cap exposure; and (8) Research new ideas for active equity management in specific targeted areas.

Discussion ensued regarding actionable items; potential improvements to the defined contribution programs; possible alternatives within passive investing strategies; options to address liquidity concerns; and researching areas where active management makes sense. The Committee discussed resources and prioritizing the themes. Staff will begin the comprehensive review of the passive exposure, including alternative indices and ways of looking at passive managers, in 2011 and bring a research paper to the Committee for further discussion as part of the 2012 annual plan. Manager monitoring is absolutely necessary and will continue to receive a high degree of focus from staff. Staff will also continue to search for additional emerging markets managers as appropriate and will research new ideas for further consideration.

[Mr. Nakahara was no longer in attendance at 4:08 p.m.]

> **Mr. Masten moved that the Public Markets Committee recommend the Board adopt the 2012 public equity annual plan. Ms. Pranger seconded, and the motion carried unanimously.**

<u>OTHER ITEMS</u>

There was no further business to come before the Public Markets Committee and the meeting adjourned at 4:13 p.m.