WASHINGTON STATE INVESTMENT BOARD
Public Markets Committee Meeting Minutes
January 7, 2014

The Public Markets Committee met in open public session at 1:01 p.m. in the boardroom at the Washington State Investment Board in Olympia, Washington.

Members Present:	Kelly Fox, Chair Marcie Frost Arlista Holman Bill Longbrake Bob Nakahara David Nierenberg
Members Absent:	Joel Sacks
Other Members Present:	George Masten Treasurer Jim McIntire
Others Present:	Theresa Whitmarsh, Executive Director Gary Bruebaker, Chief Investment Officer Phil Paroian, Senior Investment Officer – Public Equity Bill Kennett, Senior Investment Officer – Fixed Income Rhonda McNavish, Assistant Senior Investment Officer – Public Equity David Thatcher, Investment Officer – Public Equity Fletcher Wilson, Investment Officer – Public Equity Kristi Bromley, Administrative Assistant – Investments Dawn Cortez, 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 Fox identifying members present.

ADOPTION OF MINUTES

> **Ms. Holman moved to adopt the September 10, 2013, minutes. Ms. Frost seconded, and the motion carried unanimously.**

FIXED INCOME INVESTMENT DISCUSSION AND POLICY REVISION

Stable Value Fund Education Session and Savings Pool Investment Policy 2.13.200 Revision

Mr. Kennett introduced himself and stated that he would provide a brief overview of the Savings Pool program and discuss the reasoning behind staff's proposed revisions to the Savings Pool Investment Policy. The Savings Pool is a stable value fund with the primary investment objectives of ensuring safety of principal and providing adequate liquidity to meet any withdrawal requests. The Savings Pool is comprised of guaranteed investment contracts (GICs) issued by insurance companies and cash in the form of money market funds. It is a very popular investment option within the Deferred Compensation Program (DCP), representing 31 percent of the DCP program at September 30, 2013. The current Savings Pool Policy requires participating insurance companies to have an Insurance Financial Strength rating of Aa3 or better by Moody's. Given the downgrade of insurance companies over the last few years, particularly since the financial crisis, the number of insurance companies with such a rating has decreased. Only two insurance companies providing GICs to the fund meet the current rating requirement. The proposed policy revision to lower the rating one notch to A1 would increase the number of eligible insurance companies. Mr. Kennett noted that Moody's definition for Aa3 are those obligations judged to be of high quality and subject to very low credit risk and the definition for A1 are those obligations considered upper-medium grade and subject to low credit risk.

Mr. Kennett reviewed the characteristics and types of stable value funds. The WSIB utilizes GICs, which are investment contracts issued by insurance companies with coupons (interest rates) and specified maturities. GICs sit at the top of the capital structure and the obligation to participants is backed by the full financial strength and credit of the issuer. Another important characteristic of GICs is that they accrue on a book value basis and are not marked-to-market so they do not suffer losses due to changes in the market.

Ms. Frost noted the Department of Retirement Services was supportive of the proposed policy revisions. Discussion ensued regarding the structure of the GIC portfolio and the increased access to GIC issuers the change in credit rating would provide.

Mr. Fox moved the Public Markets Committee recommend the Board approve the proposed revisions to the Savings Pool Investment Policy 2.13.200. Ms. Frost seconded, and the motion carried unanimously.

PUBLIC EQUITY INVESTMENT DISCUSSION AND POLICY REVISION

Alternative Passive Recommendation and Public Markets Equity – Retirement Fund Policy 2.10.100 Revision

Mr. Paroian and Ms. McNavish introduced themselves. Mr. Paroian noted that a data error was discovered subsequent to staff's presentation on alternative passive at the September 2013 Public Markets Committee. Staff has since reviewed all the data and analyses, corrected the error, and concluded there was no change to the recommendation to replace a portion of the U.S. passive equity portfolio within the Commingled Trust Fund (CTF) with a passive product managed against a benchmark with a construction methodology, which sizes its constituents based upon fundamental variables and that emphasizes value characteristics..

Ms. McNavish noted that staff's recommendation to the Committee included the specific index that should be implemented and the required policy changes. Ms. McNavish reviewed the work and research undertaken by staff relative to alternative passive. She reviewed the characteristics, pros, and cons of the traditional market capitalization-weighted indices. There are many pros to market capitalization-weighted indices, which is why almost two thirds of the public equity portfolio's investments are in passive strategies that are measured against such indices. One of the cons of market capitalization-weighted indices is concentration risk, which can be particularly problematic during market "bubbles.". Ms. McNavish reviewed the tech bubble in 1998-99 as an example. She also reviewed the concept of rebalancing; noting that it intuitively makes sense to rebalance and this is consistent with the CTF Investment Belief relative to reversion to the mean. Rebalancing creates a buy low/sell high approach.

Ms. McNavish noted the long-term strategy of buying securities when they are inexpensive relative to their fundamentals and selling securities when their prices get expensive relative to fundamentals has worked well and is known as the value effect. While value can go in and out of favor and may underperform significantly for long periods of time, it has outperformed over the long term. Ms. McNavish reviewed a chart showing the cumulative annual excess return in the U.S. of value minus growth. She reviewed the pros of fundamental or value-weighted indices, noting they use rules based, transparent construction methodologies, and do rebalance. The two largest cons of such indices are the limited live data available and the fact that they may underperform when value is out of favor. Ms. McNavish reviewed the performance of the Russell Fundamental U.S. All Company Index as of September 30, 2013, versus the MSCI U.S. IMI Gross Index, noting that performance information for the Russell Fundamental index prior to its inception date of February 2011 was based upon back-tested data. The Russell Fundamental index has outperformed on a rolling 1, 3, 5 and 10-year periods, outperformed in most calendar years, and protected on the downside..

Ms. McNavish reviewed staff's recommendation, noting the reasons for focusing on the U.S. for implementing alternative passive management, as well as the reasons for recommending the Russell Fundamental index. She also reviewed the construction methodology of the Russell Fundamental index.

[Treasurer McIntire arrived at 1:31 p.m.]

Mr. Paroian reviewed an example of differences in how fundamental indices and market capitalization-weighted indices look at companies. Fundamental indices look at the real economic footprint of companies rather than their market capitalization weightings.

Discussion ensued regarding the large positions that companies and sectors can represent within market capitalization-weighted indices; the downside protection offered by fundamental indices; the limited live data available for fundamental indices, index reconstitution, cost; and the amount of assets managed against fundamental indices, which is approximately 1 percent of the overall U.S. market. The Committee also discussed the size of the recommendation.

> **Ms. Frost moved the Public Markets Committee recommend the Board replace $1.5 billion of the U.S. passive equity portfolio currently managed against the MSCI U.S. IMI index with a portfolio passively managed against the Russell Fundamental U.S. All Company Index and approve the proposed revisions to the Public Markets Equity – Retirement Fund Policy 2.10.100 to allow for this change. Ms. Holman seconded, and the motion carried unanimously.**

ANNUAL PLAN

<u>Public Equity Annual Plan</u>

The Public Equity team introduced themselves and Mr. Paroian provided an overview of the presentation, noting the key initiatives for 2014. Mr. Wilson reviewed the key investment beliefs of the CTF related to the public equity program, the additional beliefs that are pertinent to the program, and keys to success. Mr. Thatcher reviewed the global focus of the equity portfolio and reviewed a chart depicting the growth and development of markets/economies as they mature. Mr. Thatcher reviewed assets under management by the public equity program, as well as the governance requirements surrounding public equity searches.

Mr. Wilson reviewed the asset allocation of the CTF, noting that 43 percent of the overall portfolio's targeted allocation is to illiquid private markets. The implications for the public equity portfolio in the CTF are that public equities must remain liquid. He noted given the WSIB governance structure and resources, public equity will focus on less efficient markets and opportunities for active investments. In addition, broad mandates make sense and the current portfolio has passive mandates, as well as active global and emerging markets managers. Mr. Wilson also reviewed the public equity investment options within the various plans that include defined contribution investments. In the Labor and Industries (L&I), Guaranteed Education Tuition (GET) program, Developmental Disabilities Endowment Fund (DDEF), and the Permanent Funds, public equity is used for broad market exposure. Given that each portfolio has unique asset mix and risk considerations, implementation is through customized passive equity exposure.

Mr. Paroian reviewed public equity's accomplishments in 2013, including enhancements to the global and emerging markets programs within the CTF, changes to the target date funds within the defined contribution (DC) programs, contract renewals, and the alternative passive recommendation. He also reviewed the results of research conducted on having patience with manager undergoing periods of underperformance.

[The Committee recessed at 2:27 p.m. and reconvened at 2:40 p.m.]

Ms. McNavish reviewed the positioning of the CTF public equity portfolio as of September 30, 2013, including investment strategies, mandate type, and risk profile. Mr. Paroian reviewed the associated implications for the public equity work plan for the CTF public equity program. He also addressed implications for the work plan related to the DC programs, noting that DC is becoming a larger component of participants' retirement plans. The Total Allocation Portfolio (TAP) is still the largest component of the state's DC plans but the retirement strategy funds, which are now the default option, are growing in size and have the fastest growth of all options. The retirement strategy funds automatically adjust to a less risky portfolio as members advance in age. Discussion ensued regarding longevity risk. An education session on potential enhancements to the target date design will be provided to the Board later in 2014.

[Mr. Nakahara left the meeting at 3:11 p.m.]

Mr. Paroian reviewed the public equity assets under management in the L&I, GET, DDEF, and Permanent Funds and discussed their differing needs, risk tolerances, asset mixes, and public equity implementation, noting that customized passive strategies may grow in importance for these funds and the WSIB needs the best passive management possible.

Mr. Paroian reviewed the four broad themes for the public equity program in 2014: (1) manager monitoring and risk management; (2) enhancements to existing programs; (3) rebids or renewals; and (4) research and potential new initiatives. He also addressed the importance of allowing time for non-recurring items that require attention throughout the year. He reviewed the reasons for and challenges of each initiative and reiterated the key public equity initiatives for 2014: manager monitoring and risk management enhancements; emerging markets search; passive management rebid; and research into improving defined contribution and retirement strategy funds' asset mix.

Discussion ensued regarding manager searches, active/passive split of the portfolio, and resource needs.

Chair Fox announced that the Committee would go into executive session to discuss financial and commercial information relating to an investment 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 5 minutes, at which time the Committee would reconvene in open session.

[Committee convened in executive session at 3:33 p.m., and reconvened in open session at 3:39 p.m.]

> **Ms. Frost moved the Public Markets Committee recommend the Board adopt the 2014 Public Equity Annual Plan. Ms. Holman 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 3:40 p.m.