

WASHINGTON STATE INVESTMENT BOARD
Public Markets Committee Meeting Minutes
June 10, 2014

The Public Markets Committee met in open public session at 1:06 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
David Nierenberg
Stephen Miller
Joel Sacks

Members Absent: Bob Nakahara

Other Members Present: Treasurer Jim McIntire

Others Present: Theresa Whitmarsh, Executive Director
Gary Bruebaker, Chief Investment Officer
Phil Paroian, Senior Investment Officer – Public Equity
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
Amy Schioldager, BlackRock Institutional Trust Co.
Sara Shores, BlackRock Institutional Trust Co.
Al Goduti, BlackRock Institutional Trust Co.
Scott Powers, State Street Global Advisors
Lynn Blake, State Street Global Advisors
Sonya Park, State Street Global Advisors

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

Chair Fox called the meeting to order.

ADOPTION OF MINUTES

Ms. Holman moved to adopt the January 7, 2014, minutes.

Ms. Frost seconded, and the motion carried unanimously.

INDEX-RELATED STRATEGIES INVESTMENT MANAGEMENT SEARCH RESULTS

Introduction

Ms. McNavish introduced herself and Mr. Thatcher. She noted every WSIB plan that uses public equity employs passive investment management, and passive represents the majority, if not all, of the public equity exposure in the plans. Given the significance of passive equity management, it is very important that the WSIB partners with the very best passive providers. Ms. McNavish noted that passive management is used to gain broad-based equity exposure at the lowest possible cost.

During the Public Equity Annual Plan discussion in January, staff outlined three upcoming passive procurements and recommended they be consolidated into one process. A broad index-related manager search was launched in February with the help of Callan Associates to find the best passive investment managers for the WSIB.

Mr. Thatcher reviewed the search process, which took place over a 4-month period. The search was an open and competitive opportunity for any firm desiring to participate in the search process. Interested candidates submitted their characteristics and qualifications as outlined in the search instruction document to the consultant assisting with the search, Callan Associates, and the eVestment databases. The consultant then screened these submissions to determine if there were qualified candidates that could take on the index business of the WSIB. After discussions with the consultant, it was determined that further due diligence would be conducted on seven candidates. The consultant prepared detailed profiles and data on each of the seven firms for WSIB public equity staff to evaluate. After reviewing information and data on the seven candidates, the public equity team narrowed the field to four finalists. All necessary work determining each of the four finalist's abilities to meet the WSIB's needs was conducted, including site visits where

needed. Staff studied detailed supplemental data provided by each finalist to gain more clarity about their operations and focused on their implementation capabilities, personnel, team strengths, ability to customize, and the ability to meet the WSIB's indexing needs. One area of emphasis was their ability to manage commingled funds.

(Mr. Sacks arrived at 1:11 p.m.)

As a result of this search, staff believes the two incumbent managers are the best providers of index-related investment services for the WSIB and recommend the incumbents receive contracts to provide index-related products. This recommendation is due to their scale of assets under management, the breadth and depth of their index platforms, the tenure and experience of their teams, the sophistication of their systems, and ability to meet the needs and requests of the WSIB.

Ms. McNavish noted that staff provided a search memo along with a reference document on terminology, a list of WSIB's passive exposure, and profiles on each manager in the materials. The Committee would also have opportunity to ask questions directly of the managers during their presentations.

Mr. Nierenberg asked if the WSIB had experienced any losses related to securities lending by our index fund managers during the last financial crisis and the economic downturn of 2000-2002. Mr. Bruebaker responded the differential tightened during those periods so the WSIB made less, but the WSIB had never sustained net losses because of securities lending.

(Mr. Miller arrived at 1:13 p.m.)

State Street Global Advisors

Ms. Park introduced herself and noted SSgA's appreciation of the 20-year partnership with the WSIB and of being considered for the index manager mandate. She introduced Mr. Powers and Ms. Blake.

Mr. Powers noted that size and scale are a competitive advantage in index management as is an ongoing commitment to the area. He provided an organizational overview, noting that SSgA is the investment management arm of State Street Corporation. He stated that SSgA represents between 15 and 20 percent of revenues or profits of the broader State Street business. SSgA is core to the overall operational model of State Street. Mr. Powers reviewed SSgA's assets under management, noting that passive strategies comprised the largest percentage of their assets, and organizational structure.

Mr. Nierenberg inquired as to where the proxy voting function fit within SSgA's organizational structure. Mr. Powers responded that proxy voting is overseen by Ms. Blake, as well as their Global Investments Committee. Mr. Powers noted that, as a passive investor, SSgA does not have the ability to reflect their views by selling shares. As such, proactive discussions with companies are essential and in keeping with their fiduciary duty. Mr. Nierenberg noted the importance of paying attention to governance issues that have a direct impact on the value of the holdings.

Mr. Powers reviewed the organizational framework from governance and oversight construct, noting their focus on fiduciary duty and that everything they do is for the benefit of their clients.

Ms. Frost inquired about the dual reporting relationship of certain staff to both Mr. Powers and the corporate competency centers. Mr. Powers noted this was the case for control functions. Areas that affected delivery of services to clients were dedicated to SSgA and reflected their strong conviction to run a world-class asset management business.

Ms. Blake reviewed SSgA's philosophy and competitive advantages. She summarized their strengths, including experienced, tenured team of portfolio managers; size and scale; modular approach to product lineup; and innovative, client-tailored solutions. She reviewed the structure of the Global Equity Beta Solutions Group, as well as their assets under management and strategy types. She noted that their asset size, order

flow, and diversity of assets provided clients with significant opportunities for internal crossing.

Mr. Nierenberg noted the efficiencies of internal crossing and inquired as to how SSgA audited its own processes to ensure fairness of internal prices and trading practices. Ms. Blake noted that, as internal crossing was internal to their business, it was off market and did not involve using dark pools. Additionally, their processes are regulated by the Department of Labor. Participants and cash flows included in internal crosses have to be fair, prorated, and executed at closing market prices. They are also done completely anonymously.

Mr. Nierenberg asked how SSgA protected their clients from encroachment by high frequency traders. Mr. Powers noted that electronic trading has resulted in reduced costs but acknowledged there are also risks involved. SSgA conducts benchmarking and trade management oversight within the organization to ensure they are getting best execution on all their trades.

Mr. Longbrake inquired regarding SSgA's interactions with regulators and the unintended consequences that can come about by regulations. Mr. Powers noted that SSgA dedicates significant resources to ensuring compliance with regulations and actively engages with regulators globally.

(Treasurer McIntire left at 1:49 p.m.)

Ms. Blake reviewed SSgA's equity exposure by market segment. She provided an overview of the portfolio management process, noting that SSgA defines risk as under- or over-performance to the benchmark as they seek to match the returns and characteristics of an index as closely as possible, before expenses, over the long term. She reviewed their portfolio management risk controls. She noted that most of their portfolios are replicated to the extent possible, as is the case for the funds SSgA manages for the WSIB. As such, misweights and overall tracking error are very low.

Further discussion took place regarding proxy voting and the emphasis on the long-term performance of companies, including the emerging trend to evaluate nonfinancial metrics.

Ms. Blake discussed the importance of intelligent execution of index changes and reconstitutions, as this is one of the most critical functions an index provider has to manage. She noted that SSgA looks at every index change on a case-by-case basis to determine potential impact to the portfolio. She reviewed the MSCI reconstitution at the end of May and the graduation of Qatar and UAE from frontier to emerging market status. There was the opportunity for significant market impact and disruption. Because of that and infrastructure issues, SSgA executed away from the reconstitution date, both pre and post. They were able add value in both markets.

Ms. Blake reviewed SSgA's research capabilities and commitment to a research-driven process. Areas of focus include investment themes, understanding the investment opportunity set, and better portfolio management.

Mr. Powers summarized the presentation by stating that passive management may seem relatively straightforward, but it is actually very complicated with lots of moving parts. SSgA delivers very concise tracking at competitive price points. Accomplishing this involves significant investment in talent and technology. The research element is very important, as is the commitment to intellectual capital. SSgA's commitment to beta is core to everything they do. The organization takes seriously their fiduciary duty, which is inherent in their culture and commitment to oversight and governance. He stated their strong sense of loyalty and commitment makes them well suited to continue to serve the WSIB.

Ms. Frost inquired as to what SSgA is thinking about going forward in terms of strategy, operations, and people. Mr. Powers noted that what worked well over the past 20 years would not necessarily work for the next 20. SSgA will maintain beta as their core foundational strength but they will not stand still. They will help clients think about risk and opportunities. Their Asset Class Solutions Group is an example of where they provide value-added service to clients. Additionally, it is important

that they create opportunities for their people to be challenged, to grow and stretch. The benefit of a very strong parent company allows them to continue to invest in the business and grow. They will continue their history of innovation on their clients' behalf.

(The Committee recessed at 2:20 p.m. and reconvened at 2:27 p.m.)

BlackRock Institutional Trust Company

Mr. Goduti introduced Ms. Schioldager, Ms. Shores, and himself. He provided an overview of BTC, noting their only business is providing investment management services to clients. He reviewed their mission statement, organization facts, and assets under management. He noted that BTC has managed assets for the WSIB since 1982, through various legacy organizations. BTC's size and scale benefits clients; 45 percent of the firm's total assets under management are in equity index strategies. He noted the firm's culture and structure reinforce their client-centric approach. BTC is an independent asset manager focused only on clients with a deep understanding of regulatory requirements and a proprietary foundation for managing risk. Mr. Goduti reviewed the breakdown of BTC's assets under management, as well as their services and infrastructure.

Ms. Schioldager reviewed BTC's Beta Strategies platform, noting that indexing is anything but passive. BTC's drive to deliver consistent and reliable performance requires skill and expertise. She noted their extensive and flexible platform for beta strategies with over 1000 funds managed against 350+ benchmarks with daily liquidity. She also reviewed asset growth and the distribution of assets by region of mandate. Ms. Schioldager noted BTC's key differentiators: seek performance with precision; clients first; and constant evolution. Since their first index fund over 40 years ago, BTC has continued to be one of the first to introduce new products. She reviewed a snapshot of BTC's Beta Strategies Platform offerings, reflecting their breadth and depth of products and noting that assets are currently managed in 85 countries, as well as an organizational chart for the Americas Index Equity Beta Strategies.

Ms. Frost asked about a recent example of where BTC's research has influenced their actions. Ms. Shores provided an example related to Google's release of non-voting Class C Shares where the work of BTC's research team resulted in a positive outcome for BTC and the industry as a whole. Further discussion ensued regarding BTC's engagement with index providers to constantly seek improvements to index construction.

Ms. Schioldager discussed BTC's core investment philosophy of total performance management focused on a disciplined, objective process to manage return, risk, and cost. She reviewed BTC's index investment management process, including benchmark knowledge, portfolio construction, efficient trading, and performance and oversight. She also reviewed the framework for how BTC's portfolio managers add value, including capital market perspectives and fund-specific factors. She provided an example of what differentiates BTC focused on the UAE and Qatar index promotion in May 2014. BTC's handling of these events contributed positively to the performance of their emerging markets fund.

Mr. Sacks inquired as to the number of events such as this that BTC has to manage across its different funds. Ms. Shores noted the two biggest are the MSCI and Russell index reconstitutions. Ms. Schioldager noted they start looking at their trading strategy for these big reconstitutions months in advance.

Ms. Schioldager reviewed BTC's scale and internal crossing network, which deliver significantly lower transaction costs for clients. She also noted BTC's security lending program consistently delivers value, with positive results even during the financial crisis. BTC's foreign exchange trading is another key source of cost savings. She reviewed the performance of the WSIB's separate and commingled accounts with BTC noting their ability to deliver consistent positive performance.

Ms. Shores reiterated that BTC's approach to beta is anything but passive. She reviewed the five P's of their approach: people, performance, process, platform, and products.

Mr. Nierenberg asked how BTC protects against dark pools and how they manage the proxy voting process. Ms. Shores noted that trading is much more efficient and lower cost than it has been due to advances in technology. There are good aspects of high frequency trading which provide liquidity, as well as more nefarious aspects of those looking to game the system. She noted with index management, turnover is low and they are not exposed to high frequency traders as most of their trading occurs around the close and gaming typically does not exist around the close. The job of their trading team is to understand liquidity and how to best transact. They also understand the characteristics of the dark pools. BlackRock has made recommendations to the exchanges and Securities and Exchange Commission on ways to standardize orders and help improve the infrastructure to level the playing field and provide all investors with the same information at the same time.

Mr. Goduti noted their corporate governance staff utilizes external experts for assistance but votes proxies themselves. BTC's proxy voting process is very transparent with the results of their proxy voting published each August.

Ms. Whitmarsh noted this process is very similar to the WSIB's voting of U.S. proxies, which follows guidelines approved by the Audit Committee. The WSIB's proxy voting process is also very transparent with results posted on our website.

Discussion also ensued regarding tracking error with each BTC fund having a proscribed range for tracking error. The size of the tracking error range varies, as markets that are more inefficient are harder to replicate.

Discussion and Recommendation

Discussion ensued regarding the factors incorporated into staff's decision to recommend the two incumbent firms, including the depth and breadth of the firms, their robust systems and research abilities, ability to customize, trading and proxy voting capabilities, and the importance of competition.

Mr. Sacks moved the Public Markets Committee recommend the Board hire both incumbents, BlackRock Institutional Trust Company and State Street Global Advisors, for passive

investment management contracts, subject to continued due diligence and successful negotiation of fees, terms, and conditions. Ms. Frost 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 3:45 p.m.