

**WASHINGTON STATE INVESTMENT BOARD
Public Markets Committee Meeting Minutes
December 1, 2015**

The Public Markets Committee met in open public session at 1:00 p.m. in the boardroom at the Washington State Investment Board in Olympia, Washington.

Members Present: Joel Sacks, Chair
Marcie Frost
Arlista Holman
Stephen Miller
Bill Longbrake
David Nierenberg (teleconference)

Members Absent: Bob Nakahara
Representative Timm Ormsby

Other Members Present: George Masten

Others Present: Theresa Whitmarsh, Executive Director
Gary Bruebaker, Chief Investment Officer
Bill Kennett, Senior Investment Officer – Fixed Income
Phil Paroian, Senior Investment Officer – Public Equity
Fletcher Wilson, Investment Officer – Public Equity
Steven Glass, Zeno Consulting Group
Stacy Conway, Administrative Assistant

Mary Lobdell, Assistant Attorney General

[Names of other individuals attending the meeting are listed in the permanent record.]

Chair Sacks called the meeting to order and took roll call.

ADOPTION OF MINUTES

**Ms. Holman moved to adopt the September 1, 2015, minutes.
Mr. Miller seconded, and the motion carried unanimously.**

EDUCATION SESSION

Transaction Cost Analysis Overview

Mr. Paroian explained that public equity staff created a research project and hired Callan to complete the research and review of potential firms to provide transaction cost analysis (TCA) services for the public equity portfolio. He described the process used, which included the narrowing down of viable firms from a dozen to the final choice to retain Zeno Consulting Group.

Mr. Glass, Zeno Consulting Group, said Zeno is a specialty consulting firm, not a brokerage firm, and it does not sell trade cost analysis data or provide services to brokers, investment managers, or any other parties other than plan sponsors. In this way, the firm avoids conflicts of interest. He discussed services provided by the firm to the WSIB; the components of trading costs, providing example transactions; the importance of analyzing implementation shortfall; and the costs incurred each time a manager makes a trade, stating that trading costs are not trivial.

Discussion ensued regarding possible instances of gains instead of shortfalls, the costs associated with trading delays, and the reasons for these delays.

Mr. Glass shared transaction examples, translating basis point (bp) costs into dollars, and said these costs are incurred before any returns are earned, explaining why this matters. He discussed the peer universe and the disparity in costs, providing two important reasons for this: inattention and conflicts of interest; both of which are areas that plan sponsors can impact. Mr. Glass said attention to trading costs helps; as better tools have been developed and more attention has been given to the issue, costs have been cut in half—from 100 bps to 40-50 bps. He gave three top reasons trade cost analysis makes sense: legal, as a prudent fiduciary plan sponsor needs to be monitoring costs; it provides critical transparency into what managers are doing with fund assets; and it helps control excessive trade costs, which is one of the largest expenses of a fund.

Mr. Glass provided an overview for a peer group universe, showing the implementation shortfall and the amount that came out of the assets of the fund compared to the commission portion, and said that it is important that the fund understand the true risks in trading. He discussed the importance of having a meaningful benchmark to use as a comparison, the steps involved in making comparisons, including drilling down to see which managers are driving costs and looking for trends and following up with managers when results of the analysis appear out of place.

Mr. Glass presented an overview of the WSIB's portfolio and said it consistently ranks in the top quartile of the peer universe in total costs, execution efficiency, and commission rates.

Discussion ensued around action taken by Zeno when a manager's costs are out of the ordinary; the subsequent results from managers after investigation; use of TCA information by WSIB staff; staff communication with managers around analysis and improvements that can be made to improve efficiency; availability of data on

potential managers; ability of a manager to add value even if it is below the median range; legitimate reasons a manager may fall below the median range; differences between active and passive managers and reasons for these differences; and non-quantitative considerations.

Research on Global Small Capitalization

Mr. Wilson reminded the Committee that as part of 2015 annual plan, staff said it would research global small capitalization (small cap) for potential investment in the public equity portfolio. He noted this presentation would cover some of the research completed, but prior to making an investment recommendation, additional work would be required.

Mr. Wilson provided an overview of the public equity investment universe; the segment considered small cap; a summary of the number and size of holdings in the MSCI ACWI small cap index; and Public Equity's current small cap investments in the Commingled Trust Fund (CTF), explaining that the public equity portfolio is currently underweight in global small cap stocks versus its benchmark. He said staff considered whether the underweight should be addressed, explaining that active global managers have holdings in small cap stocks, but they are underweight for structural reasons, and gave an example of why a global manager might have difficulty investing in global small cap. He noted since active managers face these constraints, and the default investment for public equity is passive, staff's analysis included the use of a passive index investment in the MSCI ACWI small cap index. He discussed the merits of this investment and the results of the Style Research analysis completed.

Mr. Wilson explained the small cap effect—the idea that small cap stocks tend to outperform large and mid-cap stocks over the long term—and discussed related studies done to try to explain why this is the case; the difference between the large, mid and small cap index as compared to the large and mid cap only, which reflects excess (historical) returns in the index with small cap; and the costs related to the inclusion of small cap.

Discussion ensued around the costs the WSIB currently pays and additional costs to include small cap stocks, as well as potential currency effect related to global small cap investments. Mr. Wilson replied that the country weights in the global small cap index are roughly in line with the country weights in the broad global index used by public equity, so the potential additional investments in small cap should not add a significant currency effect to the portfolio.

Mr. Wilson shared some of the additional concerns resulting from the research, including the potential necessity to include a quality factor; the fact that most of the history for small cap effect is based on U.S. stocks and there is questionable statistical significance to a small cap effect outside the U.S.; and the risk that there may not be a performance advantage attributable to a size factor on a risk-adjusted basis. He said further research would be discussed in the annual planning process based on Committee feedback.

Discussion ensued regarding potential and historical small cap excess returns, the amount of staff time and resources available for further research on this topic, CTF global small cap underweight in the U.S. versus in other regions, downside risk and volatility, and guidance that could be provided to staff by the Committee.

Ms. Whitmarsh said this has been a topic of interest for quite some time, and although the analysis results are underwhelming, there is a lot of literature and hype for small cap. She said that new information and the annual planning session would provide an opportunity to make decisions and give guidance to staff.

JUNE AND DECEMBER MEETING DATES

Mr. Bruebaker presented the proposed date changes for the June and December 2016 meetings to accommodate Board member attendance at conferences and to provide consistency by holding meetings in the same week as the Private Markets Committee meetings. The proposed June meeting date is May 31, 2016, and the proposed December meeting date is November 29, 2016.

Ms. Holman moved that the Public Markets Committee approve the proposed June and December 2016 meeting date changes as presented. Mr. Miller 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 2:26 p.m.