Why the Washington State Investment Board Changed Its Strategic Asset Allocation

The WSIB is a long horizon investor. We seek to generate an 8 percent return over the long term. To achieve this result at a prudent level of risk we develop a strategic asset allocation that diversifies our holdings among four asset classes (public equity, fixed income, private equity and real estate) with different returns and risk levels to optimize the trade off between risk and return. The strategic asset allocation decision is the most consequential one the Board of the WSIB makes.

After careful study and deliberation, the Board made a significant change to its asset allocation. The Board increased WSIB's allocation for private equity from 17 percent to 25 percent; allocated 5 percent to a new asset class for the WSIB, tangible assets, and increased its allocation to real estate from 12 percent to 13 percent. The funding for the increase in private equity and real estate will come from reductions in the allocation to public equities. Tangible asset investments will be funded by reductions in the fixed income allocation.

Why did the WSIB adopt this change?

While the increase in the private equity allocation is sizeable, it is consistent with the strategy the WSIB has been successfully pursuing for years. The tangible asset allocation is new, but consistent with the intent to be innovative. The increase in the real estate allocation is incremental, to take advantage of attractive market opportunities and the capacity of existing partners to invest more capital in current strategies.

The WSIB based the private equity expansion on two fundamental beliefs. First, we believe the private equity model can sustainably produce returns in excess of public market equities over the long term. Second, we believe we have relationships today with top quartile private equity firms that will allow us to deploy capital to meet the 25 percent allocation target. We expect private equity to earn 400 basis points (4 percent) over the return earned by public equity over the long term, which is a conservative assumption based on historical spreads on our returns over the past 1, 3, 5 and 10 years. This long term commitment to an illiquid asset class plays to the strengths of the WSIB – its long horizon and limited need for liquidity. Projections indicate WSIB's long-term cash flow needs to be only 2 percent.

The WSIB has invested successfully in this asset class for more than twenty-five years and has established strong relationships with many of the most successful private equity firms in the world. These factors combined with the WSIB's demonstrated expertise in identifying and accessing new, high-quality opportunities, makes the decision to increase the target allocation to private equity a logical, appropriate, and prudent progression.

The risks associated with an even larger commitment to private equity were carefully considered by the WSIB. Foremost among these is the size of allocation itself. The WSIB is already among the largest public pension fund investors in private equity in terms of portfolio allocation. A 25 percent allocation is more typical of an endowment than a pension fund and this very difference, maverick risk, will expose the WSIB to doubt and second guessing whenever private equity results trail those of public equities. It is possible that a future Board could abandon the commitment at considerable loss if done during a period of underperformance.

Another risk is that our beliefs could prove incorrect going forward, that is, private equity may not produce better returns than public equities or our partners may not remain top quartile performers. Our beliefs are supported by strong empirical evidence both as to the power of the private equity model to produce more value than public equities and the persistence of out performance by the best general partners.

The WSIB carefully considered the liquidity needs of the retirement funds to be sure that forced sales of illiquid assets would not be required. The highest negative cash flow for the retirement funds occurred in

2003 and 2004 when contribution rates for most funds were below 1 percent. The negative cash flow never exceeded 4 percent, less than the 5 percent endowments typically pay out under their spending policies. This capacity to sustain illiquid investments over long time periods creates the ability to earn a premium, a direct advantage of the WSIB's long horizon perspective.

Tangible assets provide valuable diversification benefits while also providing the potential for attractive risk-adjusted returns. Both as a group and viewed individually as sub-groups, tangible assets are likely to have returns that are relatively uncorrelated to other asset classes or to each other. Additionally, some sectors in tangible assets have comparably strong correlations with anticipated inflation. Potentially, several tangible asset types produce long-term, high-quality, stable income streams which are advantageous for return diversification as well as investment allocation management. The Board's staff gained experience with tangible assets through two investments in infrastructure in the Innovation Portfolio, an opportunistic allocation of up to 5 percent of the portfolio.

The Board believes real estate will continue to deliver significant diversification benefits and attractive risk-adjusted returns over the long term, along with high-quality, stable income streams. As with private equity, the Board has over twenty-five years experience investing in real estate and has established strong relationships with successful real estate firms around the world. The Board's long time horizon and limited need for liquidity, when combined with WSIB's expertise in identifying and accessing new, high-quality opportunities, make this modest increase in the real estate allocation appropriate and reasonable.

This strategic asset allocation decision comes exactly one year after the process began with a series of educational sessions, in-depth discussions, and hundreds of hours of analyses. In addition to recommendations from staff, the Board also worked closely with Pension Consulting Alliance, EFI Actuaries, Capital Dynamics, and the Office of the State Actuary.

November 15, 2007