WASHINGTON STATE INVESTMENT BOARD
Board Meeting Minutes
February 17, 2011

The Washington State Investment Board met in open session at 9:46 a.m. in the boardroom at 2100 Evergreen Park Drive SW, Olympia, Washington.

Present:	Pat McElligott, Chair Treasurer Jim McIntire, Vice Chair Steve Hill William Longbrake George Masten Richard Muhlebach Bob Nakahara David Nierenberg Judi Owens Mike Ragan Judy Schurke
Absent:	Senator Lisa Brown Representative Sharon Tomiko Santos Jeff Seely
Also Present:	Theresa Whitmarsh, Executive Director Gary Bruebaker, Chief Investment Officer Victor Moore, Chief Operating Officer Liz Mendizabal, Public Affairs Director Steve Lerch, Research Director Steve Draper, Senior Investment Officer – Real Estate Tom Ruggels, Senior Investment Officer – Private Equity Diana Will, Senior Investment Officer – Asset Allocation Bill Kennett, Senior Investment Officer – Fixed Income Phil Paroian, Senior Investment Officer – Public Equity Kristi Haines, Executive Assistant Chad Standifer, Attorney General's Office Rob Arnott, Research Affiliates John West, Research Affiliates

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

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

ADOPTION OF THE DECEMBER 16, 2010, MINUTES

Treasurer McIntire moved to adopt the December 16, 2010, Board meeting minutes. Mr. Ragan seconded, and the motion carried unanimously.

COMMITTEE ASSIGNMENTS

Chair McElligott moved the Board accept his recommendation to assign Mr. Longbrake to the Public Markets Committee. Ms. Schurke seconded, and the motion carried unanimously.

ADMINISTRATIVE COMMITTEE REPORT
Non-voting Board Member Candidate Review

Chair McElligott moved to reappoint both Messrs. Nakahara and Seely as non-voting Board members for three-year terms beginning January 1, 2011, and ending December 31, 2013. Treasurer McIntire seconded, and the motion carried unanimously.

PUBLIC COMMENT
Mr. Greg Gilbert, Chief Executive Officer of Americas Institutional at Russell Investments, addressed the Board regarding its impending decision on the cash overlay program. Mr. Gilbert said that Russell Investments is based in Washington State with offices globally in 20 different countries. Russell has had a very strong partnership with the WSIB. He said Russell exceeded its anticipated performance in the cash overlay program and proven it is very competitive. It is very strong with its emerging markets capabilities, and also strong in equities and derivatives. Russell has managed the WSIB's cash overlay program since its inception. He asked the Board reconsider or delay action on the cash overlay recommendation. He said Russell is the number one provider in this space and it stands ready to serve the WSIB in any capacity.

Mr. Nierenberg said the decision is difficult. He has a positive impression with staff's capabilities and thoroughness in this procurement, and believes they do a solid job and are mindful of costs involved in making a change. He does not believe there is basis to override staff's recommendation.

IS THERE A "NEW NORMAL?" SETTING THE CONTEXT FOR CAPITAL MARKETS ASSUMPTIONS
Mr. Lerch introduced the first in a series of presentations on capital market assumptions, each of which is aimed at different aspects of the expected rate of return for the Commingled Trust Fund (CTF). He described the "new normal" phrase is a theory the U.S. economy will have below-average growth and below-average investment returns for many years for a number of reasons.

Mr. Lerch described capital markets assumptions as projected characteristics of each asset class over 15 years which provide the best estimate of asset class behavior over the long-term. They are used by Asset Allocation staff, the State Actuary, and for the Guaranteed Education Tuition (GET) program. He compared capital market assumptions from 2009 and 2010. The assumptions give a range of possible outcomes in expected returns. Staff believes there will be more interest in capital market assumptions this year because of the recession and financial market crisis. Mr. Lerch said there is great dispersion in what analysts think about return expectations. Staff also has differing

outlooks within the asset classes. These different interpretations have implications for investment strategies, including emerging markets growth, reversion to the mean, and disconnect between economy and markets.

Mr. Lerch reviewed S&P annualized returns for 10-year periods and demonstrated how different the return can look by shifting the 10-year snapshots by just one year. This is important when considering what markets did historically.

Mr. Lerch said the State Actuary uses expected CTF returns to calculate pension liabilities and contributions and makes recommendations to the Pension Funding Council on the rate of return assumption. The state law currently assumes an 8 percent return for the CTF. The State Actuary risk model brings greater attention to capital market assumptions. It is important to provide stakeholders with an understanding of the process used to develop capital market assumptions, which tempers historical data with theory and includes investment professional input. He said the CTF since inception return is 8.65 percent.

Mr. Hill said a significant issue to think through is whether it is appropriate for this generation to take credit in pension funding for the equity risk premium. The WSIB also should not only communicate what it thinks it can return, but also what it believes the risk premium is and the range of returns. Then others will decide what to use in their calculations.

Chair McElligott observed staff's recommendations have resulted in good Board decisions. The WSIB has to produce what the Legislature tells it to. If the number is outrageous, the WSIB would communicate that with the Legislature which could result in higher contributions.

Treasurer McIntire noted there is a difference between valuation calculations and numbers used to evaluate what contributions should be. Mr. Nierenberg said no matter what the expected return, the implications are how to invest money.

HOPE IS NOT A STRATEGY

Mr. West, Research Affiliates, posed the question of what steps should be taken to get 8 percent returns in light of lower capital markets assumptions. Mr. Arnott said pensions cannot be funded on capital markets assumptions alone. It is a useful exercise to know the downside and match liabilities before considering what risk premium or alpha to expect. He described historical trends and return projections for bonds, stocks, and alternatives and the effects of deficit, debt, and demographics. He proposed that fundamental index and other non-price weighted indexes, global tactical asset allocation, emerging markets and credit, long TIPs, liability driven investing, and tangible assets provide opportunities.

[The Board took a recess at 11:10 a.m., and reconvened in open session at 11:26 a.m.]

PUBLIC MARKETS COMMITTEE REPORT

Public Equity 2011 Annual Plan

Mr. Paroian reviewed highlights of three 2010 initiatives, including the CTF-Global/International search, Plans 3/Deferred Compensation Program review of options, and improving analytics. He provided details on processes undertaken, current status, and next steps for each initiative. He said 2011 will be spent completing and integrating the initiatives, implementing any changes to the Guaranteed Education Tuition asset allocation targets, investigating separate account versus commingled account structures in the CTF, and assisting with the custodian contract Request for

Proposals process. He noted some research topics that may be initiated at year end or into 2012.

Mr. Ragan moved the Board adopt the Public Equity 2011 Annual Plan. Mr. Masten seconded, and the motion carried unanimously.

Cash Overlay Recommendation

Mr. Ragan moved the Board hire State Street Global Advisors for the Cash Overlay Program mandate, subject to continuing due diligence and successful negotiation of terms and conditions. Ms. Owens seconded the motion.

Mr. Ragan reported the WSIB has had a cash overlay program since July 2006. The program has three primary goals: (1) to add a small incremental return to the CTF by eliminating cash drag across the total portfolio; (2) to keep the portfolio closer to the long-term asset allocation targets approved by the Board; and (3) to help reduce some of the short-term liquidity risk and transaction costs associated with funding benefit payments and capital calls by allowing staff to keep a large cash balance on hand. The program accomplishes its goals through purchasing futures or other derivatives in amounts proportional to the cash in the CTF in the asset classes that are underweight the Board's approved long-term asset allocation targets. He said the cash overlay manager currently is not allowed to short futures to bring overweight asset classes back to target and is not allowed to add leverage to the total portfolio. The individual external managers' portfolios are not touched, and the cash overlay program is invisible to the Board's external managers. Ms. Will led this effort and was present to answer questions.

Mr. Hill asked what the primary drivers are for making this decision. Ms. Will described the cash overlay program is customized and data intensive. Staff looked at the number of relationships each staff manages and how they build futures baskets overlay cash. She reported that Russell does not currently have an exposure to emerging markets and State Street has unique ways to access those markets. Turnover of staff was also discussed. Mr. Masten relayed while he believes we have good staff, he also represents beneficiary interests and must base his decision on the information presented which shows that Russell returned approximately 10 basis points (bps) running the program over the past 4.5 years, which exceeded their own expectation of anticipated returns. Mr. Masten also noted the close proximity of Russell's offices to the WSIB. He said nothing has been presented by staff that gives him an idea how much money the WSIB could earn going with State Street. Plus, there would be time spent on transitioning between firms. He said he plans to vote against staff's recommendation.

Ms. Will said Russell's outperformance can be attributed to capital market assumptions, WSIB staff involvement, market conditions, and how much money was in the program rather than simply Russell's expertise.

Treasurer McIntire said he had a lot of discussions with staff about this decision and he believes he fully understands why return performance is not a basis for this decision. He emphasized the complexity of the contract decision and product being purchased. WSIB does a lot of business with both companies and they are both excellent. He will support staff's recommendation.
Chair McElligott said the Committee is forwarding this recommendation to the Board and he supports that.

The above motion carried, with Mr. Masten voting no.

Plan 3 Default Legislation Discussion

> **Mr. Ragan moved the Board approve support for the draft legislation, which would establish the Retirement Strategy Funds as the default option for new members entering the Plan 3 retirement systems. Ms. Owens seconded the motion.**

Mr. Ragan reported an *Ad Hoc* Committee formed by Chair McElligott recommended the WSIB and DRS jointly support legislation to change the default Plan 3 investment option from the Total Allocation Portfolio to the Retirement Strategy funds. The Retirement Strategy funds are designed and periodically rebalanced to adjust to an individual's retirement time horizon.
Senator Lisa Brown and Representative Ross Hunter are sponsoring bills to make that change and the bills are moving quickly through the legislative process. Public hearings on the bills were held earlier this month and the proposed change was supported by the Washington Federation of State Employees. The House bill is scheduled for executive session in Committee today, and is expected to be on the House floor calendar for a vote soon.

> **The above motion carried, with Mr. Masten voting no.**

PRIVATE MARKETS COMMITTEE REPORT
Chair McElligott announced the Board 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 WSIB or would result in private loss to the providers of the information. He said the executive session was expected to last until about 10 minutes, at which time the Board will reconvene in open session.

[The Board went into executive session at 12:03 p.m., and reconvened in open public session at 12:21 p.m.]

PRIVATE EQUITY 2011 ANNUAL PLAN

> **Mr. Masten moved the Board adopt the confidential Private Equity 2011 Annual Plan that was discussed in executive session. Treasurer McIntire seconded, and the motion carried unanimously.**

KKR North American XI Fund, L.P.

> **Mr. Masten moved the Board invest up to $500 million, plus fees and expenses, in KKR North American XI Fund, L.P., subject to continuing due diligence and final negotiation of terms and conditions.**

Mr. Masten reported the fund will have a target size of $8 to $10 billion, and will invest primarily in large, franchise-leading businesses in North America, but may invest up to 25 percent of aggregate capital commitments outside of the U.S. and Canada. KKR and the WSIB have had a successful, 28-year relationship. The proposed investment is consistent with the 2011 private equity annual plan and the model portfolio approved by the Board in 2010. He said the recommendation is based,

in part, on KKR's strong franchise, deep and experienced investment team, strong and consistent long-term track record, and successful value-creation strategy.

Mr. Ragan seconded, and the motion carried unanimously.

BC European Capital Partners IX, L.P.

Mr. Masten moved that the Board invest up to €185 million, plus fees and expenses, in BC European Capital IX, LP, subject to continuing due diligence and final negotiation of terms and conditions. Treasurer McIntire seconded the motion.

Mr. Masten reported BC European Capital IX, L.P. will be a European-focused private equity fund with a target size of €6 billion. The fund will invest primarily in European businesses with enterprise values ranging from €300 million to €2 billion, although up to 25 percent of the fund may be invested outside of Europe. The WSIB has invested in three prior BC Partners funds since 1997. The proposed investment is consistent with the 2011 private equity annual plan and the model portfolio approved by the Board in 2010. He said the recommendation is based, in part, on the firm's strong historical performance with substantial realizations, proven strategy, strong franchise, experienced investment team, and institutionalized processes.

The above motion carried unanimously.

Ms. Owens said, at the December Board meeting, she had abstained from the motion relating to the Board restating its current strategy to venture capital and the motion failed. She asked for the Board to reconsider the motion at this time.

Ms. Owens moved the Board maintain the WSIB's current strategy of only investing in venture managed by general partners with a demonstrated track record of first quartile performance on an opportunistic basis. Mr. Masten seconded, and the motion carried unanimously.

GET ASSET ALLOCATION DISCUSSION AND ADVANCED COLLEGE TUITION PAYMENT PROGRAM POLICY 2.35.100 REVISION

Ms. Will said the WSIB started managing the GET portfolio in 1997. The GET is administered by a 5-member board, including the State Treasurer, Office of Financial Management Director, Higher Education Coordinating Board Chair, and two members appointed by the Governor. The WSIB has investment authority over the funds and consults with the GET Board. There have been no program changes since 2002. Ms. Will said that GET is one of the fastest growing funds, which has increased by 28 percent over the past year. Most of the contributions comes in March and April of each year as unit sales are open during that time period and it coincides with the Legislature setting college tuition amounts. She described the GET program is more like an insurance program rather than a pension program. Staff is proposing changing the equity portion to global equity and splitting the fixed income allocation to get higher returns on coupon payments. The fixed income change would be implemented by the daily Bond Fund. She noted a slightly higher return over the long-term may result in volatility over the short-term. Staff will use State Street Global Advisors as the manager of the global equity portion as a separate account at JPMorgan. Changes will not be immediate and will primarily be made with cash flows with full implementation probably in the July or August timeframe.

Treasurer McIntire moved the Board adopt the recommended changes to the Asset Allocation for the Guaranteed Education Tuition Program and accept the corresponding changes to the Advanced College Tuition Payment Program Policy 2.35.100. Mr. Ragan seconded, and the motion carried unanimously.

Treasurer McIntire thanked Ms. Will for her help with the GET program and today's recommendation.

[The Board recessed at 12:30 p.m., and reconvened in open session at 12:55 p.m.]

ADMINISTRATIVE COMMITTEE REPORT—CONTINUED

Strategic Plan

Ms. Whitmarsh said the proposed 2011 strategic plan is based on a limited resource environment and increasingly complex investment environment. It attempts to address how to maintain the WSIB franchise going forward with fewer resources. Staff will conduct an organizational review and look at other models, and plan to spend time discussing findings at the July Board meeting. It also plans a discussion of Board governance in July. Staff and the Board will also examine investment strategies that may make a difference in reaching the 8 percent return assumption.

Chair McElligott moved the Board approve the 2011 Strategic Plan. Mr. Hill seconded, and the motion carried unanimously.

Assistant Attorney General's Report

Mr. Standifer repeated his report from this morning's Administrative Committee meeting. He said the WSIB signed onto the Council of Institutional Investors' amicus briefing in support of the Securities and Exchange Commission's rule on proxy voting access. The WSIB will also be participating in negotiations of a settlement in one portion of the litigation relating to claims against former Lehman executives and directors. A limited recovery is anticipated.

INVESTMENT REFERRAL POLICY 2.05.800 ADOPTION AND ROLE OF INVESTMENT MANAGERS POLICY 1.10.200 REVISION

Ms. Whitmarsh said the proposed policies had been presented to the Board in December and members requested simplifying and syncing the policies by slight changes in the verbiage. The policies require members to only refer investments to the Executive Director if they are deemed to be of potential interest to the WSIB. The Investment Referral policy was drafted in response to an Internal Audit recommendation to increase transparency. The proposed policy also affected the language within the Role of Investment Managers policy.

Mr. Hill moved the Board adopt the Investment Referral Process Policy 2.05.800 and the revision to the Role of Investment Officers Policy 1.10.200. Ms. Owens seconded, and the motion carried unanimously.

EXECUTIVE DIRECTOR'S REPORT

Ms. Whitmarsh reported the July Board meeting would be held in Tacoma, in a publicly owned facility adjacent to the Hotel Murano. Staff is putting together the agenda, which will cover risk, governance, organizational review, and investment strategies. Ms. Whitmarsh invited members to propose speakers they believe are worthwhile. She is currently following up on one speaker recommended by Mr. Longbrake.

The Audit, Public Markets, and Board Governance *Ad Hoc* committees will each meet on March 1, and the Public Markets Committee meeting will continue on March 2. Ms. Whitmarsh introduced Raelyn Wilson, the newly hired Administrative Assistant for real estate. There are three recruitments open: Tangible Assets Senior Investment Officer, and Investment Officer positions in both Fixed Income and Real Estate.

QUARTERLY DISCUSSION OF MARKETS

Portfolio Discussion

Mr. Bruebaker said it was a good quarter. The CTF is up 4.99 percent for the three-month period ended December 31, 2010. The equity markets are up 5.8 percent. He reported the since inception return for the CTF is 8.65 percent. Mr. Bruebaker shared the WSIB's rating in the current *P&I* magazine ranking of top pension funds. He reported the Implementation Value Added analysis shows the allocation decision was assisted by overweighting in global equities and real estate. The manager decision was hurt by private and global equity, but assisted by fixed income which outperformed by 35 bps. Mr. Bruebaker said he is not optimistic of achieving the 8 percent return, but believes the portfolio is well positioned for good relative returns in the future.

Fixed Income

Mr. Kennett reported that retirement fixed income outperformed by 53 bps for the quarter and 129 bps for the year. Although returns for the fourth quarter 2010 were negative, the portfolio returned 8.45 percent for the year. The outperformance was due to an overweighting of credit, which returned 11.2 percent. He said emerging markets and non-dollar bonds performed very well. The Labor and Industries' funds performance for the quarter was above that of the CMIs due to the short duration of their Treasury holdings. The Labor and Industries' funds' annual performance was below that of their CMIs due to cash holdings and the structure of the CMIs. The Permanent Funds slightly underperformed for the quarter and one-year. Mr. Kennett believes the U.S. economy is looking stronger but he is uncertain how sustainable it is. He commented on the disturbances in the Middle East. The portfolio exposure to the Middle East is about 0.39 percent in the Labor and Industries' funds and a little over 2 percent in the retirement fixed income portfolio. He does not believe recent events will have a material effect on the portfolio.

Mr. Bruebaker commented on the average yield of the CTF compared to the returns quoted during Mr. Arnott's presentation thanks to performance by the internally managed fixed income portfolio. A discussion ensued relating to increasing exposure to non-dollar bonds. Mr. Kennett said it is not restricted by policy. He said Ms. Donna May Ong has a Board educational session planned this spring and will present information on emerging markets exposure and non-dollar bonds. Mr. Masten said Mr. Kennett has done well over time and he will support his decision making.

Mr. Hill asked about future opportunities to get into GICs, given policy restrictions and the limited market. Mr. Kennett reported he believes the product will disappear over time. Mr. Hill asked that staff work with the Department of Retirement Systems' staff to communicate clearly on this issue.

Public Equity

Mr. Paroian said 2010 was a strong year for pubic equity markets, which were up almost 15 percent. He reported that U.S. did better than non-U.S. but emerging markets are up almost 20 percent. Small cap and micro cap segments of the market performed most strongly. He believes 2011 is going to be a fairly good year, but returns will be more muted. Mr. Paroian commented on the WSIB's 0.1 percent exposure in Egypt. Staff has spoken with every manager who has exposure.

The largest weightings are with Lazard and they have talked with their representative in Cairo and received positive feedback, so staff remains cautiously confident that current issues will play out over the long-term as neutral or positive for economic freedom.

Private Equity

Mr. Ruggels pointed out the private equity quarterly report in the Board materials, which is the first report prepared by Hamilton Lane. He invited any comment from members on the report format. Mr. Ruggels said the one-year return of 15.8 percent underperformed the benchmark return of 17.08 percent, but the portfolio is outperforming over the 3-, 5-, and 10-year periods. The quarterly return is 5.78 percent, and since inception return is 13.08 percent. He said cash flow activity has continued to pick up quarter to quarter. There are more drawdowns and liquidations, with a spike during the fourth quarter 2010. He said for the year 2010, distributions and drawdowns were almost equal. Forty percent of all 2010 distributions and 30 percent of drawdowns occurred during the fourth quarter.

Real Estate

Mr. Draper reported there is positive movement in the real estate markets; however, it is capital versus fundamentally driven which is cause for mild concern. Some institutions are investing for reasons other than real estate being a good buy. He remains cautiously optimistic about market recovery. The best markets are doing very well while the others are struggling. Within the WSIB portfolio, the difference in returns of the real estate operating company holdings compared to commingled funds over the past three years was 1,390 bps. Mr. Draper said the highest returning strategy over the previous 3-year period—which may be roughly viewed as a proxy for the economic downturn—was the Emerging Markets Fund-of-Funds managed internally by Ms. Ceri Walker. It outperformed all other WSIB real estate investments by 490 bps for that period. He said the third quarter 2010 return was 3.3 percent, the ten-year return is 50 bps above the benchmark, and the income portion of the return is between 6 to 7 percent for all periods.

OTHER ITEMS

There was no further business to come before the Board and the meeting adjourned at 1:37 p.m.

Patrick McElligott
Chair

ATTEST

Theresa J. Whitmarsh
Executive Director