



Washington State Investment Board

# Strategic Plan 2009-2015



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## WSIB Mission

Invest with integrity, prudence, and skill to meet or exceed the financial objectives of those we serve.

# Strategic Framework

## Introduction

The purpose of the WSIB is to invest the funds entrusted to us in order to meet or exceed the financial objectives of those we serve. We aspire to be the best public institutional investor in the world. This means our strategy, execution, performance, and reputation must be excellent. To succeed we have identified five key drivers to our success:

### Critical Success Factors

- ☐ The five key drivers are the foundation for ensuring success in each of the essential activities of the board.
- ☐ Risk management analysis: understanding and managing risk is the foundation for investment decisions.
- ☐ Strategic asset allocation: research indicates that asset allocation is the greatest contributor to investment returns.
- ☐ Identify, evaluate and implement investment ideas: Investment ideas abound. The difference between good and great institutional investors is their ability to find and implement the best ideas.
- ☐ Select great managers: like most public pension funds, the WSIB relies on outside money managers to invest a significant portion of its funds. Gaining access to the best managers in every asset class is critical to our success.
- ☐ Construct and manage portfolios: the financial objectives of our customers vary and portfolios must be constructed with a view toward their particular income and risk goals.



### Five Key Drivers

- ☐ A skillful Board with the knowledge and capacity to make prudent investment policy decisions, oversee staff and investment managers, and faithfully carry out its fiduciary duty.
- ☐ A disciplined, long-term investment perspective that adheres to a structured, forward looking analysis and decision making process.
- ☐ Operational excellence to support continuously improving investment analysis and management, risk management, accounting and oversight, communications, and Board support.
- ☐ A work environment that attracts, develops, and retains high quality people who are committed to serving our beneficiaries with integrity, prudence, and skill.
- ☐ Impeccable integrity at all levels.





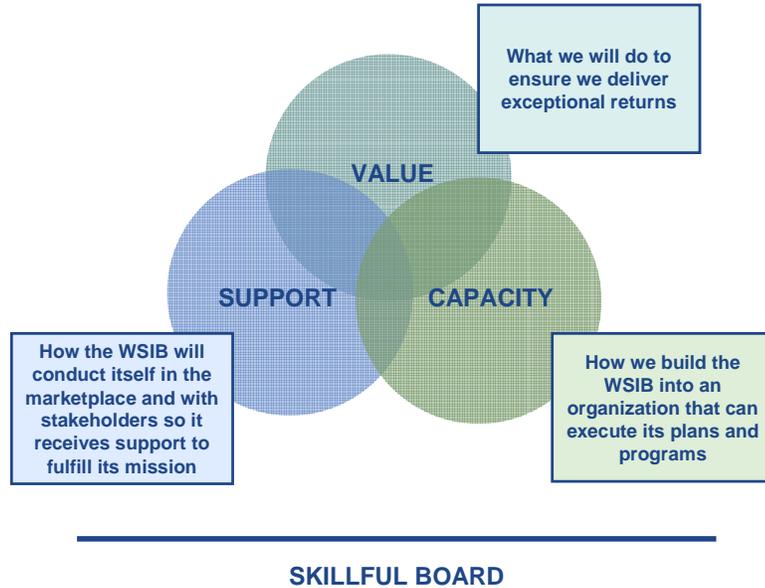
## Value

Value is described as what the WSIB will do to ensure we deliver exceptional returns.

### Executing on the Mission - Value, Support, and Capacity:

The Board builds its strategic plan around three core principles that interact with one another, as seen in the diagram below. Every planning year we ask ourselves three essential questions:

- ▣ What will we do to ensure we deliver exceptional investment returns?
- ▣ How will we build the WSIB into an organization that can execute on its plans and programs?
- ▣ How will we conduct ourselves in the marketplace and with stakeholders so we receive the support to fulfill our mission?



The foundation for delivering value, building capacity and ensuring support is a skillful board that understands its fiduciary duty and has been given the education, staff support and tools to help it fulfill its duties.

Each of our strategic initiatives advances one or more of these core principles. Fundamentally, we are looking for capacity initiatives that increase the value we bring to our beneficiaries and in turn expect that as we deliver value we will receive the support we need for resources that increase our organizational capacity. Underlying all of this is a commitment to ensuring our board has all the resources it needs to successfully lead.

## Value - Investment Program Mandate

### Goals

Have a total investment portfolio that is diversified in accordance with the principles of prudence, as well as satisfying the investment objectives of the various funds. The WSIB has responsibility for 36 funds, which are categorized in five fund types: retirement (defined benefit and defined contribution), deferred compensation, insurance, permanent and other trusts. Each fund type has unique objectives that call for a portfolio construction appropriate for the objective.





## WSIB Investment Principles

The Board shall establish investment policies and procedures designed exclusively to maximize return at a prudent level of risk. (RCW 43.33A.110)

The Board shall consider investments not in isolation, but in the context of the investment of the particular fund as a whole and as part of an overall investment strategy, which should incorporate risk and return objectives reasonably suited for that fund. (RCW 43.33A.140)

The Board shall diversify the investments of the particular fund unless, because of special circumstances, the board reasonably determines that the purposes of that fund are better served without diversifying. (RCW 43.33A.140)

1. **Retirement funds:**
  - ☐ Defined Benefit CTF (PERS 1, PERS 2/3, SERS 2/3, TRS 1, TRS 2/3, LEOFF 1, LEOFF 2, WSP 1, WSP 2, Judicial, Volunteer Firefighters): Maximize return at a prudent level of risk.
  - ☐ Defined Contribution (TRS 3, SERS 3, PERS 3, Judicial): Provide participants with a broad spectrum of well-managed, self-directed investment options.
2. **Deferred Compensation Program:** Provide participants with a broad spectrum of well-managed, self-directed investment options.
3. **Insurance funds** (Accident, Medical Aid, Pension Reserve and Supplemental Pension): Achieve highest return possible consistent with the need to: (1) maintain the solvency of the funds; (2) maintain premium rate stability; and (3) ensure sufficient assets are available to fund the expected liability payments. It is of paramount importance to coordinate the level of risk taken on by investments with the level of risk arising from insurance operations.
4. **Permanent funds** (American Indian, Agricultural, Common School, Normal School, Foster Care, Scientific, State University and Millersylvania Park): Achieve the highest return possible consistent with the desire to emphasize high current income and to add value through active management.
5. **Other Trust funds** (Game and Special Wildlife, State Employees Insurance Reserve, Radiation Perpetual, Reclamation Revolving, Budget Stabilization Account - Developmental Disabilities Endowment): Achieve the highest return possible consistent with the need to meet any liabilities.
  - ☐ Other Trust Funds--Guaranteed Education Program (GET) Program: Achieve highest return possible at a prudent level of risk to meet or exceed the rate of college tuition inflation over the long-term.

### Objectives

To achieve fund performance that is appropriate for each of the various components of the overall fund, given the unique objectives of each component, which is comparable to other large public institutional investors.

1. **Retirement funds:**
  - ☐ Defined Benefit CTF: To exceed the returns of a policy benchmark, which is a composite of appropriate market indices weighted according to our asset allocation target. (WSIB Policy 2.10.050)
  - ☐ Defined Contribution: To offer members a comprehensive range of investment options, which effectively meet the investment needs of these large and diverse constituencies, as determined in cooperation with the Employee Retirement Benefits Board. (WSIB Policy 2.11.100)
2. **Deferred Compensation Program:** To offer participants well-managed institutional investment options at low cost to meet the investment needs of this large and diverse constituency, as determined in cooperation with the Employee Retirement Benefits Board. (WSIB Policy 2.13.100)
3. **Insurance funds:** To meet the reserve and duration targets as set forth by the Department of Labor and Industries. (WSIB Policy 2.20.100)
4. **Permanent funds:** To emphasize stability of income to support operations of each irreducible trust. To actively manage the funds to exceed the return of the Lehman Aggregate Index. The objective of the Common School Fund is to maximize growth of assets while maintaining a targeted level of income to the fund. (WSIB Policy 2.25.100)



## Statutory Authority

RCW 43.33A.010:

"The State Investment Board shall exercise all the powers and perform all duties prescribed by law with respect to the investment of public trust and retirement funds."

RCW 43.84.150:

"...the State Investment Board shall have full power to invest, reinvest, manage, contract, or sell or exchange investments acquired."

RCW 41.50.080:

Investment of Retirement Systems Funds.

RCW 51.44.100:

Investment of Industrial Insurance Funds.

RCW 43.84.031:

Investment of the Permanent Funds.

RCW 43.84.170:

Investment of the Permanent Funds.

RCW 2.10.080:

Investment of Judicial Retirement System Funds.

RCW 2.14.080:

Investment of Judges' Supplemental Retirement Funds.

5. **Other Trust funds:** To emphasize stability of income to support operations or liabilities of each respective fund. To actively manage the funds to exceed the return of each funds' respective benchmark. (WSIB Policies 2.35.100, 2.35.200, 2.35.300, 2.35.400)

- ☐ GET Program: To generate a 4.5 percent real rate of return (CPI + 4.5 percent).

### Strategies:

1, 2:

- ☐ Continually determine, review, alter, implement, and monitor a prudent asset allocation policy for each class of funds.
- ☐ Evaluate satisfaction with custom portfolios and adjust to meet customer need.
- ☐ Review investment options in Defined Contribution and Defined Benefit plans and implement in investments as needed.

3, 4, 5:

- ☐ Evaluate satisfaction with custom portfolios and adjust to meet customer need.

### Measurements / Benchmarks

1. **Retirement funds:**

- ☐ Implementation value added
- ☐ Each option has its own benchmark, such as the Dow Jones Wilshire 5000, etc.

2. **Deferred Compensation Program:** Each option has its own benchmark, such as the Russell 3000, etc.

3. **Insurance funds:** The Comparable Market Indices duration targets

4. **Permanent funds:** Lehman Aggregate Index. Common School Fund: Lehman and Wilshire 5000, based on asset allocation

5. **Other Trust funds:** Custom benchmark based on asset allocation

## Value - Assets under Management

### Goals

Manage each asset class to meet the unique goals of the different funds. Each fund type contains various asset classes appropriate to achieve the fund's investment objectives. Each asset class has its own rate of return objectives.

1. **Public Equity:** Achieve the highest return possible consistent with the desire to control asset volatility, and diversify the overall investment program.
2. **Fixed Income:** Receive the highest return possible consistent with the unique goals and requirements of each fund type and diversify the overall investment program.
3. **Real Estate:** Produce a well diversified and profitable real estate portfolio, enhance the returns to the overall investment program, and diversify the overall investment program.
4. **Private Equity:** Produce a well diversified and profitable private equity portfolio, enhance the returns to the overall investment program, and diversify the overall investment program.
5. **Tangibles:** Enhance the returns to the overall investment program, and diversify the overall investment program.





## Statutory Authority

RCW 28B.95.070:  
Investment of Advanced College Tuition Payment Program Funds.

RCW 1.05.140(2):  
Investment of Health Care Authority Insurance Funds (State Employee's Insurance Reserve).

RCW 41.24.030:  
Investment of Volunteer Firefighters' Relief and Pension Funds.

RCW 41.34.060:  
Investment of Defined Contribution Retirement Funds.

RCW 43.33A.190:  
Investment of Defined Contribution Self-Directed Retirement Funds.

RCW 41.50.780:  
Investment of Deferred Compensation Funds.

RCW 70.121.050:  
Investment of Radiation Perpetual Maintenance Funds.

RCW 77.12.323:  
Investment of Special Wildlife Account

## Objectives

1. **Public Equity:**
  - ☐ Global Equity: Meet or exceed the returns of the Dow Jones Wilshire Global total market Index.—
  - ☐ Public equity components of the Insurance Funds and the Guaranteed Education Tuition program are managed to meet or exceed the returns of the MSCI ACW IMI
2. **Fixed Income:**
  - ☐ Retirement funds: Exceed the returns of the Lehman Universal Index, with volatility similar to or less than the index.
  - ☐ Insurance funds: Meet the reserve and duration targets as set forth by the Department of Labor and Industries.
  - ☐ Permanent funds: Exceed the returns of the appropriate benchmark index, which for the majority of the funds is the Lehman Aggregate Index.
  - ☐ Other Trust funds: Effectively manage within customized policy objectives.
3. **Real Estate:** Maximize total returns within a prudent level of risk by investing in the real estate equity and debt markets, which can be expected to deliver a risk-adjusted return premium of 100 basis points over the NCREIF benchmark.
4. **Private Equity:** Achieve superior total returns compared to traditional asset classes and exceed returns in large capitalization public stocks by 500 basis points in the long run.
5. **Tangibles:** Provide a stable source of income and appreciation commensurate with inflation.

## Strategies

1. **Public Equity:** Manage the equity portfolio globally with an appropriate level of tracking error.
  2. **Fixed Income:** Achieve the highest risk adjusted return consistent with the desire to control asset volatility.
  3. **Real Estate:** Expand global corporate and public real estate strategies, while trying to manage to the target of 13 percent of the CTF.
  4. **Private Equity:** Expand investment in emerging market opportunities and small/mid corporate restructuring while leveraging successful existing relationships to manage private equity exposure to 25 percent of the CTF.
  5. **Tangibles:** Expand diversity of portfolio by both sector and global expansion.
- 1, 2, 3, 4,5:
- ☐ Develop precise performance measurement methodologies for CTF, based on selected risk strategy.

## Measurements / Benchmarks

1, 2, 3, 4, 5: See Measurements / Benchmarks on page 4.



## Statutory Authority

RCW 43.33A.030:  
Investment of  
Emergency Reserve  
Fund.

RCW 43.79.495:  
Investment of Budget  
Stabilization Account.

RCW 43.330.205:  
Investment of  
Developmental  
Disabilities Fund.

RCW 41.05.140(4):  
Investment of Basic  
Health Fund

## Capacity

Capacity is defined as how we build the WSIB into an organization that can execute its plans and programs.

## Capacity

### Goals

The general investment environment has continued to become more complex and competitive, making it harder to deliver value in the future. Returns from traditional asset classes may be entering a period of cyclical decline. If so, achieving the 8 percent return objective set by the legislature will be more difficult. To meet the challenge, the WSIB needs to increase capacity to manage global funds and asset classes new to the WSIB including tangible assets, active marketable securities funds and other innovative vehicle. We must also improve our risk management program by integrating qualitative and quantitative analyses into processes and decisions. We have to continue our focus on becoming a destination employer so we can attract and retain qualified staff. And we must maintain the conviction to stay with an investment strategy during periods when the strategy causes underperformance relative to peer institutional investors.

The WSIB has adopted two themes to address the challenges (which are further described in the following section pertaining to environment). The themes encompass initiatives to:

1. **Broaden our reach:** discern and prepare for where the next successes will come from.
  - ▣ Global markets focus, with increased exposure to emerging markets
  - ▣ Investment vehicles/strategies new to the WSIB
    - ▣ Tangible assets, active management strategies
2. **Deepen our insights and oversight.**
  - ▣ Gain insight into our risks
    - ▣ Fiduciary, market, strategic, governmental environment, operational, and reputation
    - ▣ By asset class and at the total portfolio level
  - ▣ Understand what has driven our performance and build on it
  - ▣ Thorough research, including attribution analysis
  - ▣ Ensure adequate oversight and monitoring of our investments
  - ▣ Investment accounting, compliance, internal audit, corporate governance

### Objectives

1. Sustain excellent investment performance
2. Enhance Risk Management and Control
3. Strength technology infrastructure
4. Align organizational capacity

### Strategies - Sustaining Excellent Investment Performance

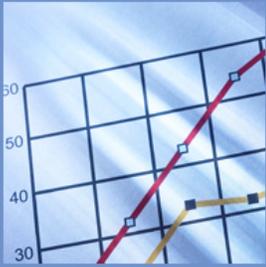
1. **Asset Allocation & Portfolio Risk Management** - The WSIB has worked primarily in silos with each asset class analyzing their own risk at the asset class level. Additional resources will allow us to:
  - ▣ Work across the asset class and analyze the entire portfolio risk
  - ▣ Assist the Board to make informed investment decision with the risk clearly understood
2. **Public Equity** - Consider new markets and strategies, including emerging markets and active strategies. The Board may consider moving away from long only strategy and





lift the short constraint. Currently the program has only two staff managing 26 investment manager relationships. To increase oversight or add new strategies will require new staff. The program is also looking to enhance the data and analytics systems that it uses to analyze investment manager strategy and performance.

3. **Private Equity** - Gain exposure to emerging markets through current general partner relationships and selective new relationships and improve oversight, monitoring and sourcing of private equity relationships through increasing the number of staff so each investment officer maintains oversight of 8-10 relationships.
4. **Fixed Income** - Extend emerging markets investments and evaluate new types of securities and structures. This will require additional investment officers to expand credit analysis capability and expand security types used in portfolio.
5. **Real Estate** - Increase exposure to international developed markets and emerging markets through existing relationships and selective additions. The program is also considering using the Real Estate Operating Company (REOC) structure to generate fees from investments by other institutional investors.
6. **Tangible Assets** - This new asset class was approved by the Board in 2007, with a plan to reach the 5 percent allocation target by 2011. In order to do this the Board will need new investment officers to source new investment partners and deals and investment management and consulting firms specializing in tangible assets.
7. **Research** - Today, WSIB has a nascent research program which we want to expand with the acquisition of data that will allow us to:
  - ▣ Analyze relationships of investments across the entire portfolio
  - ▣ Identify changing relationships among different investments during good or bad economic periods and to analyze how various investment strategies would have performed over time
  - ▣ Detect opportunities for improving portfolio diversification to reduce risk
    - ▣ Test new investment strategies
  - ▣ Peer review/strategy research advisory council
    - ▣ Important component of research is peer review. WSIB has tapped into intellectual capital of our investment partners for analysis and education, but this is limited to volunteer analysis
    - ▣ Staff proposes creating a strategic research advisory council to act as a peer to review research methods and advise on conclusions
      - ▣ Combination of academics from various disciplines
      - ▣ Meet and review our analysis several times a year
      - ▣ Advise our research director, management team, and the Board
      - ▣ Help us think outside the box
    - ▣ Board education - the WSIB would like to conduct an annual research workshop to highlight findings of the program.
8. **Corporate governance** - potential expansion of corporate governance program
  - ▣ Strengthen proxy voting program by instituting share-recall capabilities for domestic equities
  - ▣ Expand proxy voting to international equities
  - ▣ Increase public presence as a voice for ESG initiatives (environmental sustainability, social responsibility, governance)
  - ▣ Actively engage companies regarding governance issues



- ▣ Future policy considerations for the Board
  - ▣ Divestment initiatives
  - ▣ Active U.S. equities strategy to support ESG initiatives

### Measurements / Benchmarks

1, 2, 3, 4, 5, 6, 7, 8: See Measurements / Benchmarks on page 4.

### Strategies - Enhancing risk management and control

#### 1. Risk analysis and reporting

- ▣ The WSIB's current risk management structure does not analyze all of the potential risks of every investment product, innovation, or change to processes. The goal is to build a robust risk analysis and reporting process to:
  - ▣ Reduce "surprises"
  - ▣ Identify unwanted risk
  - ▣ Ensure key risks are managed
  - ▣ Promote better communication between front, middle, and back-office functions

#### 2. Compliance - The existing compliance program covers two-thirds of total assets (public equity, fixed income, and private equity). We are extending the program to real estate, but are only able to conduct limited compliance tests because since so little can be automated. In addition, new investment initiatives will require expansion of compliance program. To address these needs the WSIB will:

- ▣ establish relationship(s) with a legal or accounting firm which can perform compliance tests on the real estate partners
- ▣ add staff resources over time to perform tests on new asset classes
- ▣ procure the services of a data integrator for real estate and tangible assets data to assist in automating some compliance and risk tests.

#### 3. Internal Audit - Staff have identified in excess of 100 possible audit areas and current staffing allows up to 8 internal audits each year, plus oversees external audits for financial reporting, information technology security, and state auditor performance and special audits. As investment programs expand, the program plans to expand to provide additional oversight or the new asset classes and investment vehicles.

### Measurements / Benchmarks

1, 2, 3: See Measurements / Benchmarks on page 4.

### Strategies - Strengthen Technology Infrastructure

1. **Build out risk system** - the backbone of sound investment decisions is a comprehensive understanding of risk. The WSIB plans to build a risk system that will provide:
  - ▣ Risk modeling
  - ▣ Stress Testing
  - ▣ Exposure Analysis
  - ▣ Risk budgeting





- ☐ The goal is to be able to look across all of our holdings and understand how the portfolio acts as a whole under various market movements, as well as to better understand where the portfolio is correlated.
- 2. **Procure real estate data integrator services and analytics system** - Unlike public securities, real estate partnerships do not follow any data standards, nor do they use similar accounting systems across partnerships that feed analytic systems. In order to gain data to conduct risk analysis or compliance on real estate partners, the WSIB will need to contract with a firm that specializes in data mapping and integration so it can convert paper-based and spreadsheet based files into electronic files.
- 3. **Establish additional fixed income and public equity analytics** - Many analytic systems exist to support public securities portfolio management. Staff uses several of these systems today. This initiative is intended to further explore tools and selectively deploy.

### Measurements / Benchmarks

1, 2, 3: See Measurements / Benchmarks on page 4.

### Strategies - Aligning Organizational Capacity

1. Investment Operations
  - ☐ Investment Accounting
    - ☐ Move to daily close to support daily performance reporting
    - ☐ Development of private market valuations expertise to comply with new audit standards
  - ☐ Portfolio Administration - The workload for this unit has increased three-fold in the last several years as the WSIB has seen a significant increase in real estate and private equity deal flow, the global focus of the portfolio has increased volume and complexity of tax and legal issues and the LLC structure for real estate has added manual processing workload. To be more efficient with existing resources the PA staff will:
    - ☐ conduct a back office review with a special focus on cash management processes and expense ticketing to seek operational improvements, freeing up staff capacity for increased workload
2. Agency Infrastructure: Information systems and finance and administrative services have seen significantly increased workloads, creating key person risk in several areas. The WSIB will be seeking additional staff and work on further cross training of existing staff.
3. Internship program
  - ☐ Develop formal internship program, reaching out to finance and business schools, to aid with recruitment for investment officer positions
4. Compensation: The legislature in 2008 approved establishing an incentive compensation plan for investment officers to aid in recruitment and retention, based on the Board developing a performance management system.
  - ☐ Develop and implement a performance management plan for investment officers

### Measurements / Benchmarks

1, 2, 3, 4: See Measurements / Benchmarks on page 4.





## Support

Support is defined as how the WSIB will conduct itself in the marketplace and with stakeholders so it receives support to fulfill its mission. This section describes and analyzes the internal and external environment in which the WSIB operates. It sketches out the strategic approach the WSIB intends to pursue in the coming years.

## Support

### Background and Recent Developments

The WSIB is entering the third phase in its development. Created in 1981, the WSIB has seen its assets under management (AUM) grow from \$5.5 billion to \$69.9 billion by March 2006. The first phase involved staffing up, developing investment strategies and policies made possible by removing restrictions on investing in corporate securities by the voters, and implementing those policies. From the beginning, the Board employed innovative approaches including passive equity investments in U.S. stocks and investment in private equity (venture capital and corporate buyouts) and taking dominant positions in private equity and real estate investments.

The second phase of the Board's development occurred in the late 1980's and early 1990's when it shifted from a staff-driven to a board-driven approach to governance, policy and decision making. This shift was prompted by disappointments in the private equity portfolio and the desire of the trustees to assert greater direction of the Board's affairs. New staff was added with specialized expertise in separate asset classes and investment accounting was brought in house. Under a new executive director, the Board developed comprehensive investment policies and procedures, a code of ethics, its current organizational structure of standing committees who prepare investment decisions for Board approval, improved performance reporting, and use of external consultants for private equity, real estate, manager selection, and asset allocation. Through this work, the WSIB established a reputation for innovation, performance and cost effectiveness.

The Board entered its third phase in 2002 when it hired a new executive director with the charge to regain the Board's innovative edge, improve its communications with beneficiaries and policy makers, enhance its investment systems technology, improve Board governance practices, increase trust between Board and staff, and improve investment performance. The Board has made great strides in each of these areas and has entered a new phase of planning for an even more challenging investment environment.

### Strategy and Capacity Assessment

Like most investors, the WSIB rode the boom of the 1990's to tremendous growth in AUM, including significant expansion of investment in private equity and increasing use of Board controlled investment in real estate operating companies. The exhilarating returns drove the funding status of the defined benefit retirement plans to fully funded status (with one exception) and simultaneously enabled significant contribution rate reductions that helped state agencies, school districts, and local governments cope with budget cuts necessitated by rising service demand and declining revenues.

Hindsight reveals how quickly things can change. The astonishing gains of the late 1990's rapidly disappeared into three years of negative equity returns in the U.S. and around the world. The collapse of technology, telecommunications, and media companies revealed the extent of the delusions suffered by most investors. Junk bond debt of many of these businesses turned nearly or completely worthless and the value of many portfolio companies in venture capital funds raised in 1999 and 2000 evaporated. The morning after had a double whammy: AUM fell and liabilities increased because equity values contracted sharply and liabilities jumped as interest rates fell to 30-year lows. While the funded status of the retirement plans remained comparatively healthy, contribution rates stand poised for steep increases (although this will only take them back to historical levels).





As the asset manager, the WSIB looks out to an environment in which the returns of the roaring 90's will be fondly remembered as a time when high investment returns were seemingly easy to obtain. After the equity bubble popped returns suffered. Over the past 3 years markets rebounded particularly in private equity and real estate and the WSIB's performance has been well above average. It may seem like a deliberate exercise in lowering expectations to say that the WSIB believes that it will be extremely challenging to attain the expected 8 percent rate of return for the CTF in the coming years, but that is no exaggeration. Our forecast for capital market returns over the next 10 to 20 years set forth our assumptions about asset class returns, volatility and correlations. They are not encouraging. We note that asset class returns tend to be mean reverting, that is, periods of exceptional above average returns are followed by periods of well below average returns. These periods of return regimes last from 10 to 20 years. If this problem holds in the coming years, that 8 percent return target will indeed be challenging. The WSIB's large allocation to private equity and real estate, its focus on cost, risk, portfolio construction and manager research and selection are all indication of how seriously we take the return objective we have been given.

The WSIB's fundamental beliefs about investment include a belief that developed economy equity markets are extremely efficient. This means it is exceptionally difficult to earn above market returns on a sustained basis. Accordingly, the Board's policy is to earn a market return (the average return for all equities in the U.S. for example) in exceptionally low cost commingled index funds. We believe venture capital, distressed debt, and corporate buyout markets are somewhat less efficient, meaning that investors with exceptional insight and skill can earn above market returns. This explains why the WSIB maintains a distinctively large allocation to private equity and real estate. The WSIB's ability to achieve the 8 percent rate of return assumed in the funding policies of the state require above average success in these two asset classes, and only average performance in publicly traded domestic and international equity and fixed income.

Other institutional investors also see the benefits of higher allocations to private equity and increased safety in real estate. As more capital floods into real estate and private equity, returns can be expected to decline, adding pressure to the Board to extend its commitments to its best managers, cull out weaker performers, and find the best of the emerging managers. It will be critically important to augment the WSIB's staff, research, and analytical capacity to cope with this increasing challenge.

### More Challenges

If increasing competitive investment markets are not enough of a challenge, the WSIB is also coping with realities of the corporate governance scandals epitomized by Enron and WorldCom. This called for stepped up intervention in corporate governance, including exercise of the Board's proxy voting capacity and regulatory initiatives of the Securities and Exchange Commission, the Public Company Accounting and Oversight Board, other government agencies, and the investment industry's self regulatory organizations.

The WSIB contracts for outside investment management, custodial banking, and investment accounting services, which are delivered via computer connections. Several investment data subscription services are also connected to the agency's computer network. It is essential that the WSIB have state-of-the-art technology systems appropriate for complex investment management and accounting requirements. Outside service providers continually update and upgrade their systems, and the WSIB must be positioned to interface to those systems to obtain the full benefit from current investment analytics and accounting information.



The WSIB has developed and continues to develop more comprehensive internal systems and data repositories using database management and office automation applications. All these internal and external resources are essential and must be readily available to staff who need them to meet the agency's complex investment management and accounting requirements.

### Staffing Resources

The WSIB must employ a staff of a size and quality appropriate to the complexity, size, type, and magnitude of the investment funds. The number of staff is expected to grow, as the size of assets increase and new and innovative investment programs are added. Current staff size is 73.4 FTEs. Total assets under management are \$81.9 billion as of March 31, 2008. Current staff-to-asset ratio is approximately: 1 to \$1.116 billion.

Currently, most of the asset management is contracted out to external money managers except for fixed income management (which is performed internally by the WSIB employees). As the number of external managers and partnerships increase, an increase in internal staff required to monitor the managers and partnerships is expected to occur. Projections for the long term depend on various factors, such as change in the asset size, investment asset allocation policy, number of investment funds, and/or investment strategies. Assessment of internal versus external management of funds, active versus passive management, and other decisions can also directly impact needed resources to fund agency activities.

In recent years, the WSIB has become trustee for defined contribution retirement plans (Deferred Compensation Program, TRS 3 and SERS 3 and PERS 3) and for other participant trust programs (Guaranteed Education Tuition and Developmental Disabilities Endowment Trust Fund). The WSIB also invests and manages the assets for the participant-directed Judges Supplemental Retirement Fund. In March, 2002, the PERS 3 defined contribution hybrid retirement plan came under the trusteeship of the WSIB. These forms of retirement plans and trust programs, the concept of individual trust accounts and participant directed investments, have radically and irrevocably changed the way in which the WSIB must function as a trustee. The WSIB now creates and offers daily-valued investment vehicles to individual participants in defined contribution retirement and deferred compensation programs. Private sources of funds not previously invested, such as the Developmental Disabilities Endowment Trust Fund, add taxable accounting and investing to WSIB's current processes.

### Personal Service Contracts and Legal Services

The WSIB will continue to contract with qualified independent professional consultants, advisors, money managers, and other contract services to assist in its investment management responsibilities. This process will continue to utilize the OFM statutes and regulations that govern the competitive procurement and contracting of professional personal services. The policy direction to rely on external resources will continue.

In addition to the legal services provided by the Attorney General's Office (AGO), the WSIB pays for external legal services that specialize in specific investment areas. These firms are contracted through the AGO and appointed as Special Assistant Attorneys General. Since this is pursuant to state law, it is anticipated this trend will continue and legal services costs paid through these types of contracts will continue to increase, especially when the investment world continues to demand strong ethics and good governance.



## Funding

All expenses of the WSIB are funded from the earnings of the funds managed by the WSIB. No general fund monies are involved, unless appropriated by the Legislature due to special legislative mandates. The WSIB's total proposed budget for the next biennium is .050 percent of the total assets managed (currently \$81.9 billion) equivalent to about 2.5 "basis points" per annum. This compares very favorably to other public pension plans of our size across the nation. Earnings on investments will more than cover the WSIB's operating costs, as well as achieve the projected investment performance benchmarks.

The whole investment arena is becoming more competitive as markets globalize, demands for better returns escalate, and new investment vehicles are employed. While the WSIB must remain aware of its status as a state agency with its attendant requirements for transparency and democratic accountability, it must also recognize that it is an investment manager operating in ruthlessly competitive global markets and accordingly adopt the tools, strategies, discipline, knowledge, and outlook of the world's best investment managers. The purpose of this plan is to enable that to happen.

### Defined Benefit Retirement Fund

March 31, 2008	
Qtr	-3.6%
1 Year	5.4%
3 Year	13.5%
5 Year	15.3%
10 Year	8.2%

## Performance Assessment

### Performance Highlights

- ▣ Total assets of funds managed by the WSIB is \$81.9 billion as of March 31, 2008.
- ▣ Washington's four individual Industrial Insurance Funds all had positive one-year returns ending March 31, 2008, with the highest being 6.99 percent return on the Supplemental Pension Fund.
- ▣ The combined market value of the permanent funds as of March 31, 2008 is \$795 million.
- ▣ Other Trusts totaled approximately \$1.8 billion as of March 31, 2008. As of March 31, 2008 they all have positive returns for the quarter, one-, three-, five- and ten-year time frames.
- ▣ Defined contribution assets are at \$9.0 billion in five separate programs: Deferred Compensation Program, Judicial Retirement Account, School Employees' Retirement System Plan 3, Teachers' Retirement System Plan 3, and Public Employees' Retirement System Plan 3.

## Organizational Chart

