



STATE OF WASHINGTON
STATE INVESTMENT BOARD

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June 17, 2013

TO: David Schumacher, Director
Office of Financial Management

FROM: Theresa J. Whitmarsh
Executive Director

SUBJECT: CONTINGENCY PLANNING FOR WASHINGTON STATE INVESTMENT BOARD OPERATIONS ON JULY 1

Thank you for the opportunity to respond to your June 12, 2013, memo with regard to contingency planning for operations should the Legislature fail to make an appropriation by July 1, 2013. In this memo I will address:

- Services that do not require an appropriation
- Services to continue based on certain constitutional mandates and federal law
- Services needed to avoid catastrophic loss of property

Background

As of March 31, 2013, the WSIB has under management \$74.7 billion in investments for 17 retirement plans for public employees, teachers, school employees, law enforcement officers, firefighters, and judges; \$14.1 billion in industrial insurance trust funds; and \$3.2 billion in permanent funds that benefit higher education, and other trust funds, including the Guaranteed Education Tuition program and the Development Disabilities Endowment Fund. Total assets under management as of March 31 are \$92 billion. All WSIB expenses are paid for from investment earnings and administrative fees paid by those for whom we manage money. The WSIB does not receive any monies from the general fund.

Services that do not require an appropriation

The WSIB's budget consists of appropriated and non-appropriated expenses. The bulk of WSIB's expenses are non-appropriated—nearly 96 percent. Non-appropriated expenses include all money managers and consultant fees, investment research, and legal fees specifically related to investments. Appropriated expenses, which make up four percent of our budget, include staff salaries and benefits, facilities, office equipment, and travel.

While investment expenses are non-appropriated, all WSIB operating expenses are appropriated, including staff salaries for our 82 FTEs. In the event of a government shut-down, unless the WSIB is exempted, it would not have staff able to exercise the actions necessary to ensure the flow of cash necessary to support various activities that would otherwise continue in the absence of an

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operating budget. Nor would the agency be able to fulfill its fiduciary duty to trust fund beneficiaries or its contractual obligations to business partners.

Services to continue based on constitutional mandate and federal law

Our assigned Assistant Attorney General has advised us that we are legally required to continue operations needed to ensure the flow of promised retirement benefits and the management/flow of the trust funds under our investment authority, including funds containing private assets of Washington citizens.

The state cannot impair its contractual obligations to retirees and members of public defined benefit retirement plans; its contracts between the state and beneficiaries of other trust funds, some of which contain private assets; nor its contracts with investment partners.

Similar to the Office of the State Treasurer, the WSIB sits in the center of essential cash flows that support constitutionally protected retirement benefits and other benefits that are not subject to appropriation. Our average daily transfer of retirement funds through the OST to beneficiaries is \$13,064,005. The high daily transfer from the WSIB to OST this last year was \$93,400,000. The WSIB also receives significant funds from employee and employer contributions that must be invested daily to avoid cash drag on investment performance. Daily contributions averaged \$2,483,574 over the last year, with a high of \$21,700,000 on a single day.

Services needed to avoid catastrophic loss of property

Failure to keep the WSIB open could expose the state to significant liability for breaching its fiduciary duties as well as damage claims under federal and state securities laws. The WSIB has a duty to prudently manage the investment funds under its authority. Without staff to monitor and manage the investments, the state would face potential claims from beneficiaries of those investment funds for breach of fiduciary duty; security fraud claims from our Plan 457(a) deferred compensation, defined contribution, Guaranteed Education Tuition (GET), and Developmental Disabilities Endowment Fund (DDEF) participants failing to disclose the possibility that they would lose access to their funds and WSIB oversight of the managers; and breach of contract claims or liquidated damages related to the investment contracts.

I've attached a description of functions necessary to meet the WSIB obligations, and as you can see by the attached, it encompasses the entire organization. We've always operated very lean and it takes the full complement of staff to support daily investing activity and active monitoring of a global portfolio, consisting of more than 12,000 holdings in 74 countries in 49 currencies.

Based on our analysis and guidance from our AAG, we find it essential for the WSIB to remain fully operational and request your support in assisting us with meeting our fiduciary and contractual obligations.

Attachment

cc: Treasurer James L. McIntire, Board Chair
Victor Moore, Chief Operating Officer/Chief Financial Officer

Attachment to Contingency Planning for Washington State Investment Board Operations on July 1

WSIB Critical Services: Investing

Fixed Income

WSIB staff actively manages in-house more than \$30 billion in fixed income assets across retirement, industrial insurance, deferred compensation, permanent, higher education, and other funds. The funds are all exposed to interest rate, credit, and reinvestment risk. In addition, the retirement fund is exposed to foreign currency risks.

Due to the size of the portfolios and the risks involved, sizable losses could result if not properly managed. Of the \$30 billion of assets, \$17 billion is invested in credit, mostly corporate bonds. The current market environment of extreme volatility makes active risk management critical. The volatility creates opportunities that would be missed in the absence of management. The prices of some bonds are the cheapest they've been in a couple of years.

Conversely, timely sales prevent significant losses. For example, although defaults are very rare, in a default, a bond can lose eighty percent or more of its value. Some corporate holdings, across all funds, total more than \$200 million. The WSIB has avoided significant losses by being early to sell distressed credits.

Real Estate

The WSIB uses a distinct model among institutional investors for real estate investing. It has established 25 Real Estate Operating Companies (REOCs), where ownership is shared between the WSIB and management, with the WSIB being the majority owner and retaining governance rights over the REOCs. Total assets in the REOC strategy comprise close to \$6.9 billion of the total \$9.2 billion real estate portfolio. WSIB has final authority for acquisitions and disposition of property; approval of financing agreements and leverage levels; and property valuations used in the establishment of the unit price of the Total Allocation Portfolio (TAP), which Plan 3 members' trade in and out of monthly. These decisions are brought to the real estate staff daily.

WSIB staff sits on the boards of REOCs and have authority for hiring/removal of senior management of companies; approval of annual business plans and amendments to them; and approval of operating budgets and monitoring budget to actuals. Some REOCs have July/June fiscal year ends and it is a busy time for staff, with numerous decisions coming to the boards and staff the next several weeks.

In addition, legal agreements with investment partners require timely funding of capital call requests. Not meeting these obligations can cause the WSIB to be in legal default, which may bring about material financial or other penalties. Staff also sits on Advisory Committees set up to manage and resolve conflicts of interest within investment partnerships, where action must be taken in a timely manner.

Innovation Portfolio Resource Based Equities

The WSIB staff actively manages a \$185 million in-house global equity portfolio made up of commodity producing company publicly-traded equities. In addition to monitoring and trading, staff votes the proxies, responds to corporate action requests, and trades currency on the portfolio.

Public Equity

The WSIB relies heavily on external money managers to invest its \$30 billion public equity portfolio. While day to day investing is outsourced, WSIB cannot as a fiduciary outsource risk management or allocation decisions.

Such allocation decisions include: WSIB staff is responsible for rebalancing assets among strategies and managers according to investment policy and market conditions; for raising cash for capital calls from real estate and private equity partners, as well as to fund payments to beneficiaries; for investing cash received—from capital distributions of our partners, from rebalancing activities, and/or from contributions—into our external public equity managers; and for coordinating with the Department of Retirement Systems (DRS) to ensure that daily cash flows into and transfers among Plan 3 member-directed 401(a) accounts and DCP 457 accounts are effectively and promptly invested .

As for risk management, public equity markets have shown significant volatility in the recent past. On any day, a market event (e.g. a development in the way Europe is handling its crises) can trigger large swings, up or down, in equity markets to which staff may have to respond. Furthermore, changes at external investment managers can occur at any time and may require immediate action in order to protect our stakeholders' funds from significant capital loss. Terminating external money managers and transitioning assets is one of the WSIB's most important, though rarely exercised, duties. Events precipitating termination can be sudden. Just this year the WSIB learned that the senior portfolio manager of a global equity manager was leaving to pursue another opportunity and taking much of his team with him. Within 24 hours, WSIB moved for immediate termination and transition, and within one week the assets were in the process of being transitioned. Investors who waited saw the portfolio decline substantially in the following weeks.

Private Equity/Tangible Assets

WSIB is a limited partner in over 200 private equity funds, with a total portfolio value of more than \$16 billion producing annual returns in excess of 13 percent since inception. The WSIB has a contractual obligation to each fund to meet capital calls within a few days of notice from the general partner. If WSIB fails to timely fund a capital call, it may be declared in default and would be subject to extraordinary large liquidated damages. Due to the nature of private market investing, our partners are often not in a position to give us much advance notice as to when they will require capital, due to the uncertain nature of closing dates and terms on any given acquisition. WSIB staff needs to be available, often times on relatively short notice, to negotiate and sign closing documents, subscription agreements, and contract amendments on a timely basis. Failure to do so could result in the loss of a significant investment opportunity. WSIB staff serves on the advisory committees of our major partners; actively monitor the portfolios, advises on appropriateness of general partner valuations; and approves capital calls.

Trade Confirmation and Settlement

Operations staff in Portfolio Administration is responsible for confirming and settling the trades initiated by the fixed income and resource equities traders. Trades need to be confirmed with the operations side of the broker and released to the custodian bank for settlement so that cash and securities can move properly to settle the trade on time.

Timely settlement not only impacts performance, it is also crucial to maintaining a strong reputation in the market. Brokers favor investors that quickly and consistently settle their trades. Broker relationships are essential to gaining access upon issuance to heavily subscribed securities.

WSIB Critical Services: Total Portfolio Rebalancing/ Cash Management

Portfolio Rebalancing/Cash Management

In portfolio management, disciplined rebalancing as financial markets move is the foundation of minimizing downside risk and maximizing investment return opportunities. The WSIB asset allocation staff monitors its positions daily and rebalances to stay within Board adopted policy targets for each of its asset classes. Significant losses could occur to the fund if it did not monitor and rebalance, particularly during times of strong market volatility.

Asset Allocation principal responsibilities:

- Ensure the WSIB has access to cash to fund capital calls and other obligations
- Invest cash distributions received from investment managers
- Rebalance asset allocation
- Monitor cash overlay program

Commingled Trust Fund (CTF)

As of May 31, 2013, the commingled trust fund (CTF) net asset value totaled \$69 billion. On a daily basis, the WSIB is responsible for investing funds that are distributed from investment managers and for contributing/transmitting funds to investment managers (meeting capital calls). The daily flows into and out of the cash portfolio of the CTF can be significant. For example, over the last five years, the largest cash out flow the CTF experienced in a single day was \$472 million. The WSIB receives notices for investment out flows over a relatively short time period and must be able to liquidate investments in order to fund contributions. Large cash contributions may take multiple days to raise from invested assets in a prudent manner. All private markets asset classes maintain large unfunded commitment balances and are subject to capital calls at any time.

In terms of cash flows coming in to the cash portfolio, as recently as December 2012, the WSIB received \$390 million in a single day. In that same month, the WSIB received an additional \$385 million in the last five business days of the month. If the WSIB would not have been closed that month, beneficiaries could potentially have been negatively impacted by not investing \$775 million in the markets. We generally receive very little notice on incoming distributions of funds and flows are monitored daily.

To eliminate cash drag on the portfolios, cash balances in the CTF are fully securitized in markets through the use of a cash balance overlay manager. The effects of the overlay program are to provide market exposure in line with the WSIB's strategic asset allocation. The WSIB would most likely amend the overlay program to securitize a smaller portion of the cash balance to make sure, when operating on a lag, the overlay manager didn't accidentally put the CTF into a leveraged position (i.e., securitize more cash than was actually present in the account). Securitizing a smaller portion of the portfolio would increase the cash drag on the portfolios.

The DRS receives a monthly cash transfer from the CTF on the first business day of the month. Over the last year, the average monthly distribution amount was \$118 million.

In addition to CTF accounts, the asset allocation unit is responsible for maintaining policy asset allocation as markets and cash flow events cause allocations to change from the policy for other stakeholder accounts. Rebalancing activities are fundamental to the objectives of a responsible long-term investor. It is Asset Allocation's responsibility to maintain careful monitoring of stakeholder accounts, especially during tumultuous market environments, to ensure essential rebalancing activities occur in a timely manner.

Labor and Industries Funds (LNI)

As of June 11, 2013, the LNI portfolios' aggregate net asset value totaled nearly \$14 billion. Asset allocation staff monitors the asset allocation mix and is responsible for rebalancing back to targets as appropriate. Asset allocation changes during volatile periods need to be closely monitored.

Guaranteed Education Tuition (GET) Program

The assets in this program are purchased with private funds supplied by participants and held in trust for the participant and their beneficiaries. The WSIB is responsible for ensuring sufficient assets are available to fund college tuition payments. As cash comes into the GET program, funds are invested in accordance with achieving a maximum return at a prudent level of risk. In anticipation of heavy tuition payment periods, investments are reduced to raise cash to pay tuition. The high tuition periods have historically been in August and January. As an example, GET tuition payments totaled \$31 million in August 2012. During those periods, cash flow needs to be monitored very carefully to ensure tuition payments are made. If the GET office is closed, the WSIB may not need to make those payments.

Developmental Disabilities Endowment Trust Fund (DDEF)

The assets in this program are purchased with private funds supplied by the participants and held in trust for the participant and their beneficiaries. WSIB is responsible for investing private funds that are contributed to the Trust fund. The WSIB receives transfer instructions from DDEF to invest. We typically do this on a monthly basis. WSIB is responsible for maintaining policy asset allocation for the State DDEF funds. These DDEF assets belong to private citizens of the state of Washington to cover certain allowable expenses and they have the right to access these funds at any point in time.

WSIB Critical Services: Supporting Participant Trading

Daily Valued Funds

The WSIB operates internally managed investment funds, similar to a retail investors mutual funds, that participants are provide for daily trading from participants (Deferred Compensation Program, Judicial Retirement Account, and Plan 3s). Operations staff authorizes the movement of cash into and out of the investment vehicles, unitize the daily trades by participant group and price the securities within the funds, striking a unit price.

WSIB Critical Services: Cash Management/Disbursements to Asset Owners

Investment Accounting

- CTF pricing and cash flows: Investment accounting reconciles all data to bank records and computes a price per unit of the TAP by the 15th business day of the month which allows participants to buy and sell units during the monthly opening.
- On the first business day of the month, the WSIB transfers money between DRS accounts and the CTF based on the cash needs identified by DRS for the upcoming month. If the CTF were unable to transfer cash from DRS, the impact would be investment balances remain un-invested and sitting in lower earning vehicles. Conversely, if DRS needed funding for the upcoming month in order to honor benefit payments, funds would not be available for this purpose. On average, the WSIB has been liquidating approximately \$125 million of CTF cash balances on the first business day of the month to cover the monthly cash needs of DRS.
- Daily cash transfers to / from stakeholders:

Investment accounting transfers cash daily to the state treasurer to enable our stakeholders to cover warrants issued by each agency. In addition, cash balances are transferred from the state treasurer to invest excess stakeholder cash balances in longer term securities earning higher rates. On average the WSIB transfers cash between WSIB accounts and the state treasury in the following amounts each day:

For the period 6/1/2012 to 5/31/2013				
Average Daily Transfer			High Daily Transfer	
	To WSIB	From WSIB	To WSIB	From WSIB
LNI	4,188,402.49	(4,402,516.77)	64,319,000.00	(71,732,000.00)
GET	822,363.10	(3,011,363.64)	7,500,116.54	(14,000,000.00)
Retirement	2,483,574.82	(13,064,005.56)	21,700,000.00	(93,400,000.00)

Control point for cash movement, income payments, expense payments:

- Investment accounting reconciles cash movements daily and independently checks the custodian bank to verify cash flows are authorized, received in a timely manner, and reinvested the same day. This control prevents unauthorized withdrawals from our accounts, ensures all entitlements are received by the fund, and trades settle in a timely fashion.
- This control also ensures all excess cash is reinvested to short term investment funds same day for full investment of cash balances. Un-invested cash is considered a liability on the balance sheet of our custodian bank. In the event of a bank failure, the WSIB would be considered a creditor of the bank and would most likely lose a significant portion of the un-invested cash. FDIC insurance is minimal in relationship to the losses we could be exposed to.
- Part of this process involves verifying all the income due the funds is received by the custodian bank. Our largest income payment date we process roughly \$175 million of income receipts.

Income payments range from thousands of dollars to several million dollars each. Missing one payment could result in a substantial loss to the state.

Permanent Funds:

- Investment accounting transfers new corpus received from DNR to the WSIB accounts for long term investment in income producing securities. This occurs on the first business day of the month and has averaged about \$1.1 million per month over the last year. Leaving the balances sitting in shorter term investments can result in missed market opportunities and lower distributable income currently and in the future.
- Investment accounting distributes income to the colleges once a month. The average distribution is \$2.8 million per month over the last year. Distributions would need to wait until the State approves a budget to transfer the funds to the college for expenditure purposes.
- Investment accounting monitors excess cash balances and computes the rebalancing necessary from bonds to equities to reach our 30 percent equity target allocation. On average, this rebalancing ranged from \$3.5 million to \$20.1 million per month over the last several months. If we miss our monthly opening, cash will remain un-invested in short term securities. Our current earnings rate for distributions is approximately 3.8 percent. The short term money market fund rate is .01 percent. The difference in earnings for a 1 month period on \$20 million is \$63,000 in lost revenue to the beneficiaries. In addition, market opportunities could be missed if the cash remained outside the long term investment pools until the next monthly opening.

Risk and Compliance

The WSIB has staff that operates a robust internal risk and compliance system independent of the investment team that monitors positions in the portfolio daily and advises the WSIB investment staff when their portfolios may move out of compliance with Board-adopted investment policies. Policies can breach for a variety of reasons based on market movements, credit quality degradation, etc. Compliance staff notifies and work with the investment officers to quickly come back into policy compliance. This independent oversight is standard in the investment industry and integral to the robust and transparent control structure the WSIB has put in place.

Other Support Functions

In order to support the above duties, the WSIB relies on its information services, contracts, fiscal, human resource and other support staff.