Oregon Investment Council
MINUTES
January 18, 2006

The Oregon Investment Council was called to order at 9:05 a.m. by Gerard Drummond.

OIC Members Present: Paul Cleary, Gerard Drummond, Katy Durant, Randall Edwards, Mark Gardiner and Richard Solomon.

Staff Present: Brad Child, Jay Fewel, Linda Haglund, Norma Harvey, Andy Hayes, Wei Huang, Perrin Lim, Kevin Max, Mike Mueller, Kevin Nordhill, Ron Schmitz and McKenzie Tennent.

Consultants Present: Mike Beasley, Strategic Investment Solutions (SIS)
John Meier, Strategic Investment Solutions
Tara Blackburn, Pacific Corporate Group (PCG)
Allan Emkin, Pension Consulting Alliance (PCA)
Nan Leake, Pension Consulting Alliance
Mike Moy, Pension Consulting Alliance

Legal Counsel: D. Kevin Carlson, Oregon Department of Justice

I. 9:05 am: Review and Approval of Minutes – 12/7/05

MOTION: Richard Solomon moved approval of the December 7, 2005 OIC Minutes. The motion was seconded by Randall Edwards and passed by the Council.

9:06 am: Ron Schmitz updated the Council regarding recent Private Equity and Real Estate Committee Activity:

- ❖ Private Equity Committee – TCV Fund VI/$25 million 11/30/2005
- ❖ Real Estate Committee – Woodburne Re-up/$30 million 12/28/2005

II. 9:07 am: KKR 2006 Fund – Presentation & Recommendation

Jay Fewel addressed the Council and reviewed the successful relationship between OPERF and KKR since 1981, as well as the exceptional returns. He outlined the Private Equity Portfolio long-term objective of no more than 25% maximum exposure to any one general manager. He noted that KKR originally occupied 100% of the Private Equity portfolio, but are currently about one-third.

He introduced George Roberts and Mike Michelson to discuss the proposed investment. The KKR 2006 Fund is being formed by the General Partner to pursue a broad range of equity and equity-related investments, primarily in large cap companies in North American and European markets. The Fund will continue the strategy successfully implemented over the last twenty-nine years in the firm's prior eleven private equity investment funds. The Fund will seek to make investments that require between $150 million and $600 million in equity. In addition, KKR may invest in transactions alongside major global operating companies as well as other private equity firms. The Fund will follow a control-oriented investment approach, with a focus on identifying opportunities for value creation through a combination of growth (organic and/or by acquisition), strategic redirection, and/or cost optimization. The expected average holding period for portfolio company investments is between three and seven years, in line with KKR's historical average holding period for its 1993 and 1996 funds (4.9 years and 3.7 years, respectively). The General Partner will make a capital commitment of at least $150 million to the Fund.

Mr. Roberts outlined the OPERF/KKR relationship as follows:

- ❖ The Oregon Investment Council has been a leading investor with KKR since 1981.
- ❖ The OIC has invested $3.2 billion with KKR.
- ❖ KKR has returned $5.9 billion in realized proceeds and created $4.1 billion in profits for the OIC.
- ❖ KKR Funds have generated a 19.7% IRR and a 2.3x multiple on invested capital for the OIC.

Mr. Michelson outlined KKR's investment strategy and systematic approach to value creation and noted the competitive advantage of 29 years of investing experience. KKR's track record, team and internal processes were discussed as well as global relationships. Historic performance by funds, historical cash flows and projected future cash flows were reviewed.

Mr. Michelson and Mr. Roberts answered questions from the Council.

Mr. Drummond noted that Mr. Roberts and Mr. Michelson had met individually with members of the OIC to discuss the proposed investment. He encouraged the Council to revisit the KKR 2006 Fund prior to closing and possibly consider an additional allocation.

Jay Fewel and Tara Blackburn discussed management fees, the OPERF private equity manager allocation and answered questions from the OIC.

MOTION: Randall Edwards moved that the OIC authorize a $1.5 billion commitment to KKR 2006 Fund, L.P. and to revisit the Fund prior to closing and possibly consider an additional allocation. Said commitment is subject to the satisfactory negotiation of the requisite legal documents by legal counsel working in concert with OST Staff and PCG. The motion was seconded by Mark Gardiner and passed unanimously by the Council.

III. 10:04 am: Real Estate Policy Recommendations – Policy 4.04.01

Brad Child addressed the Council and noted that during the November OIC meeting, the Council requested prudent strategies designed to address changes in the real estate investment environment. He noted that revisions to the existing policy are needed to: 1) provide an allocation to "value added" investments that fit between core and opportunistic investment relative to risk/reward; 2) provide for prudent use of increased leverage; and 3) allow for global investing outside the U.S. borders in opportunistic, REIT and value added areas. These changes will allow staff to broaden the use of current programs and increase its range of new investment programs providing a more diversified portfolio.

Ron Schmitz noted that the recommended changes had been reviewed and approved by PCA.

MOTION: Mark Gardiner moved approval of staff recommended revisions to Real Estate Policy 4.04.01. The motion was seconded by Randall Edwards and passed unanimously by the Council.

IV. 10:10 am: Keystone Industrial Fund – Presentation & Recommendation

Brad Child outlined the staff recommendation and introduced Jeff Kelter and Bob Savage of KTR Capital Partners. The Keystone Industrial Fund has been formed by KTR Capital Partners, headed by a team of nine principals with extensive experience acquiring, operating and selling industrial properties. The principals were all senior managers of Keystone Property Trust ("KPT"), a public REIT. KPT was formed in 1997 under the direction of Jeffrey Kelter, CEO. The company was sold to ProLogis (another public REIT) in 2004 for $1.6 billion. The principals believe that the current market requires the application of financial, operating and development skills to achieve attractive returns (target IRR from 13% to 15%). They have created an experienced team with these skills to invest for the Keystone Industrial Fund. This includes the nine principals and eight additional staff (five of these employees were also from KPT). This team has already acquired over $60 million of industrial properties in 2005 in four states for the Keystone Industrial Fund. They expect the portfolio to be heavily weighted to the east coast and mid-west states, where the team has the most experience and industry contacts. They target a mix of stabilized, "value-add" and development deals with the goal of creating a core portfolio rather than buying one. Capital committed to development will be limited to 25% of the fund. Their strategy takes advantage of the stable business climate and improving industrial demand fundamentals. It also avoids the need to acquire properties in bid situations where yields are compressed. The fund has a three year commitment period. It allows for capital returned from sales or refinance to be reinvested during the commitment period.

Mr. Kelter and Mr. Savage discussed the investment experience, proven performance, management team and outlined Keystone property trust milestones. Investment strategy, infrastructure and performance were addressed and questions answered from the Council.

Brad Child and Nan Leake addressed the Council and answered questions regarding fee negotiations. Katy Durant expressed concerns regarding the size of the commitment.

MOTION: Richard Solomon moved approval of a commitment of $100 million to Keystone Industrial Fund, L.P. and an additional $50 million for possible co-investment, on a case by case basis, with authority to approve each co-investment transaction delegated to staff. Such commitments are subject to satisfactory review by staff and DOJ of the fund documents. The motion was seconded by Randall Edwards.

Votes:	Katy Durant	No
	Gerard Drummond	Yes
	Randall Edwards	Yes
	Mark Gardiner	No
	Richard Solomon	Yes

The motion passed.

11:05 am: Mr. Drummond announced that item number seven on the agenda would be moved up at this time.

NOTE: Item #7 on the agenda was moved ahead.

<u>*VII. 11:05 am: SAIF Annual Review</u>

Mike Mueller introduced Brenda Rocklin, President and CEO and Jerry Dykes, Vice President and CFO of the SAIF Corporation. Mr. Dykes noted that in January of 2005, SAIF made significant changes and have implemented all of those in 2005. He further noted that SAIF was not recommending any changes at this time.

Ms. Rocklin and Mr. Dykes presented the SAIF Annual Review and presented a strategy overview, compliance overview and peer analysis.

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Key changes approved by the OIC in 2005, and implemented by Treasury staff and SAIF, included:

1. The elimination of convertible bonds from the SAIF portfolio.
2. Increasing the target allocation to domestic equities from 10% to 15%.
3. Increasing the target allocation to domestic fixed income from 82% to 85%, with a target duration of 7.0 years (over a two-year period) and a new custom benchmark more reflective of the investment universe to be used by the managers.

4. Targeting 5% of the domestic equity allocation as enhanced equity, using BGI's Russell 3000 Alpha Tilts product.

Ms. Rocklin and Mr. Dykes answered questions from the Council.

V. 11:30 am: Domestic Equity Policy Recommendations

Kevin Nordhill and Mike Beasley addressed the Council and outlined staff recommendations for policy updates related to equities as follows:

4.05.07 – Staff is proposing to reduce the commission recapture policies from three separate policies (4.05.07 to 4.05.09) to one policy. This is a housekeeping change.

4.05.10 – Staff is proposing to eliminate the requirement to obtain annual audited financial statements for commingled trusts and agreeing the reported price to the custodian bank. The price is reported by the various trusts monthly, and staff sees little benefit to performing this annually. Historically, no differences have been noted from the audited financial statements.

4.05.11 – Manager Target Allocations

Staff is recommending a number of small changes to the manager target ranges. Thompson Rubinstein resigned their account effective December 31, 2005. Staff and SIS do not recommend a replacement manager. Rather, staff proposes to reallocate Thompson Rubinstein's two percent allocation to four existing managers, as follows:

The most significant change is recommending an increase to the MFS allocation target from 3.0 percent to 4.5 percent, for the following reasons:

- MFS and AJO were hired in January 2003 to replace a single manager and their allocations were therefore smaller than the other large cap value manager (AllianceBernstein).
- In 2004, AJO's allocation was increased to make the large cap value manager allocations more equal. The MFS allocation was left unchanged since a co-portfolio manager had retired and staff was monitoring issues related to mutual fund market timing.
- The MFS market timing issue, which resulted in the termination of the CIO, appears to be behind them.
- Staff and SIS have had more time to evaluate the product portfolio manager and are comfortable with his abilities to manage the fund going forward.
- MFS has faced a headwind with their investment process (preference for larger market cap stocks and high quality companies) much of the last two years, while AJO has benefited by their smaller average weighted

market cap bias. Staff and SIS believe it is a good time to bring MFS up to equal weight with the other large cap value managers.

In addition to MFS, the allocation targets for Alliance Capital, Wells Capital Select, and Mazama Capital will each increase 0.5 percent. To maintain the structural value/growth neutrality of the portfolio, AllianceBernstein's and AJO's target allocations will be reduced by 0.5 percent. The details can be seen in Appendix D of the policy.

4.05.11 – Ark Asset Management – Staff recommends moving half of the OPERF allocation in the Ark's Large Cap Growth product, currently 4.5 percent, to their Concentrated Growth product. The Concentrated Growth product should produce higher excess returns, but also take additional risk. The Concentrated Growth product hold 20-35 names as opposed to the Large Cap Growth product's 50-75 names. The Concentrated Growth product is a newer product with much fewer assets. However, it is the same process and team, merely taking bigger bets in their highest conviction stocks. The additional risk to the DEF as a whole is negligible.

4.05.11 – Smallcap Overweight - By policy, the OIC employs a strategy to overweight small cap stocks by 40 percent in the Domestic Equity Fund. This is based on the Council's belief that inefficiencies in the small cap market relative to the large cap market, through active management, will outperform large cap stocks over the long term. The OIC's strategy to apply a 40 percent overweight to small cap stocks has produced excellent results over the last five years; the Russell 2500 has out-performed the Russell 1000 by 961 basis points annualized as of November 30, 2005. Small cap stocks now appear expensive relative to historic norms. Excesses and extremes tend to correct themselves in financial markets and staff believes the recent small cap stock out-performance is such an event. The Russell 2500 currently comprises approximately 19 percent of the Russell 3000 benchmark used for the Domestic Equity Fund. The 40 percent overweight results in a targeted 8 percent overweight to SMID cap stocks. This is a very large bet and both staff and SIS believe it is prudent to have staff flexibility to reduce the risk when circumstances warrant.

4.05.11 – Tracking Error - Tracking error is a standard deviation measure of how close a set of returns tracks a benchmark. Market volatility can cause general spikes in tracking error measurements. Staff and SIS feel it is more prudent to establish tracking error target ranges as opposed to a specific percentage. 1 to 2.5 percent is the recommended range. The last tracking error measurement for the DEF was just over 1 percent.

4.05.12 – Tracking Error - Staff and SIS feel it is more prudent to establish tracking error target ranges as opposed to a specific percentage. 1 to 3 percent is the recommended range for international equities. The last tracking error measurement for the IEF was just over 1 percent.

Mike Beasley pointed out an adjustment in Appendix A, and answered questions regarding modeling of each manager and how the strategic target ranges are calculated. Allan Emkin commented on manager target allocations, delegation to staff and monitoring.

MOTION: Mark Gardiner moved approval of staff recommendations to revise policies 4.05.10, 4.05.11 and 4.05.12, with a modification to policy 4.05.11 changing the Small Cap Overweight range on Appendix A.3.a to 0 – 50%. The motion was seconded by Katy Durant and passed unanimously by the Council.

MOTION: Richard Solomon moved approval of staff recommendations to replace OIC policies 4.05.07, 4.05.08 and 4.05.09 with policy 4.05.07 and to authorize the movement of one-half of the OPERF assets in the Ark Large Cap Growth product to the Ark Concentrated Growth product. The motion was seconded by Katy Durant and passed unanimously by the Council.

VI. 11:58 am: OIC Board Governance Recommendations and Policies 4.01.16 & 4.01.18

Ron Schmitz addressed the OIC regarding the action item and the discussion item. He noted that Mike Mueller and Mike Beasley would address the Council regarding housekeeping policy updates. Subsequently, Allan Emkin and Mike Moy would join a discussion of the issue of OIC time allocation to each asset class and staff delegation. Mr. Schmitz further noted that a specific delegation policy was not recommended at this time.

Mike Mueller and Mike Beasley outlined housekeeping/updating recommendations to two policies.

MOTION: Richard Solomon moved approval of staff proposed changes to Summary of Key Investment Duties and Functions, Statement of Fund Governance for OPERF and Statement of Investment Objectives and Policy Framework for OPERF and policies 4.01.16 and 4.01.18. The motion was seconded by Randall Edwards and passed unanimously by the Council.

Mike Beasley, Allan Emkin and Mike Moy discussed increasing the role of delegated decision making in the management of private equity and real estate portfolios. The increased delegation assumes a high level of confidence in the staff and external advisors and the goal is enhanced efficiency and flexibility. After discussion, Mr. Emkin suggested staff and PCA return with alternatives and models of staff delegation to examine. He also recommended studying peer groups and their delegation roles.

Staff and consultants were directed by the Council to return to the OIC with recommendations, models and options regarding delegation.

12:21 pm: Election of Chair and Vice-Chair

Mr. Drummond confirmed with staff that the election of OIC Chair and Vice-chair as an action item which had been officially posted. He noted that his OIC term had ended and a new OIC member, Harry Demorest, would be joining the OIC in February. He advised the Council to elect a new chair and vice-chair. He also noted that a new voting member of the OIC was needed for the Private Equity Committee and the Real Estate Committee.

MOTION: Randall Edwards moved to elect Richard Solomon as a voting member of the Private Equity Committee and Katy Durant for the Real Estate Committee. The motion was seconded by Mark Gardiner and passed unanimously by the Council.

MOTION: Katy Durant moved to elect Richard Solomon as OIC Chair and Randall Edwards as Vice-chair. The motion was seconded by Mark Gardiner and passed unanimously by the Council.

VIII. 12:26 pm: Asset Allocations & NAV Updates

Ron Schmitz reported that asset allocation and NAV updates are all within policy parameters.

IX. 12:29 pm: Calendar – Future Agenda Items

Ron Schmitz reviewed the forward calendar of agenda items.

X. 12:30 Public Comment

There were no comments from the public.

Randall Edwards thanked Mr. Drummond for his years of incredible leadership on the OIC.

The meeting adjourned at 12:30 p.m.

Respectfully submitted,

Norma Harvey
Investment Coordinator