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# Investor profile: Washington State doubles down on private markets

The \$120.4bn fund is an outlier in its asset allocation strategy, but its CIO is confident that private markets will outperform public markets over the long term

Dietrich Knauth | 06 Oct 2017

The **Washington State Investment Board** (WSIB) is more committed to private markets than most of its institutional peers, recently allocating nearly half of its \$120.4bn in assets to private equity, real estate and tangible assets.

The new allocation doubles down on Washington State's already-aggressive commitment to private markets, widening the gap with other public pension funds, most of whom favor higher targets for global and domestic public equity - asset classes that have offered high returns at relatively low costs since the 2008 financial crash.

CIO **Gary Bruebaker** acknowledges that Washington State is something of an outlier in its asset allocation strategy, but said the reason behind it is simple - Washington expects private markets to outperform public markets over the long term

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“Our since-inception [1981] return is 484 basis points higher than our public equity return,” Bruebaker told *MMR*. “Securing the financial future for over 400,000 public employees is the reason we invest in private markets.”

At its September meeting, the board approved a four-year asset allocation strategy that cuts its public equity target from 37% to 32% and uses those savings to increase real estate from 15% to 18% and tangible assets from 5% to 7% (***MMR*, 9/26/17**). The board left both fixed income and private equity unchanged, at 20% and 23%, respectively, but would have committed more to private equity if it thought it could realistically achieve those goals, Bruebaker said.

### **Private equity**

Washington State has some advantages in private equity, mostly stemming from its years of experience. The board began investing in private equity in 1981 and placed a heavier emphasis on private equity and real estate beginning in 1997, before Bruebaker became CIO in 2001. WSIB hasn't looked back since, and it prides itself on serving as a genuine partner to its general partners, rather than haranguing them over high fees.

“People who have just come to the table in the last five to 10 years couldn't even buy the kind of relationships that we have,” Bruebaker said. “We serve as an adviser for every single fund that we invest in, and we try to really add value. We never go and be a thorn in the general partner's side just so we can show everyone how smart we are.”

Bruebaker sees a lot of misunderstanding around private equity, particularly in critics' focus on fees and transparency. For Bruebaker, fees are a non-issue, as long as a private equity firm can deliver good risk-adjusted net returns to Washington.

“If I had a partner, and I don't have any, who I was paying 30 - 40% carry to, if the net return to me justifies the expense, I would gladly pay it,” Bruebaker said. “I'm not going to have a myopic focus on fees, I think that people who do that really miss the boat.”

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Bruebaker says he'd like to beat the 23% allocation target for private equity, and the board's new asset allocation allows for a range of plus-or-minus 4%.

"The board will be very happy if we can get above it, and we will if we can, but I'm going to be honest, it's going to be a challenge to even get up to the 23%."

One factor that complicates Washington's search is the trend of general partners using more subscription lines - a strategy that delays drawing capital from limited partners, and instead uses their commitments as collateral to secure a bank loan as an interim step. Subscription lines slow limited partners' ability to actually allocate capital to private equity commitments, Bruebaker said. Beyond that, competition for top general partners and funds make it harder for Washington to do things that it has done in the past, such as put up all of the money that needs to be raised for a new fund, essentially buying the right to be a sole limited partner.

"We have been cut back with some really great partners who we'd rather not be cut back by, so we're working really hard to add new relationships, and we'll continue to do that," Bruebaker said. "We'll continue to work very closely with our partners to be one of those first calls when they have a one-off strategy."

## **Real estate**

Washington is currently closer to its new 18% target for real estate than its previous 15% target, but Bruebaker said that that had no influence on the new allocation. Washington has plans to sell two real estate assets that would bring the asset class back to 15%, so the state will be both buying and selling in the next four years, Bruebaker said. The asset class has 20-year returns of 10.9% for WSIB, and about 70-80% of those returns come from cash income.

"I love real estate, and I'm extremely comfortable taking real estate to 18%," Bruebaker said. "Long-term stable income stream is the mantra for that program. That's the core of everything that we do."

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Washington State has a different approach to real estate than many other public funds. It doesn't invest in REITs or in real estate funds that include multiple limited partners, for one thing.

"A public REIT has a stronger correlation to small to midcap stocks than it does to real estate, so we don't consider REITs to be real estate," Bruebaker said.

Instead, WSIB focuses on partnerships that allow it to call the shots on key investment decisions, up to and including firing the general partner. WSIB invests through four intermediaries, and it is looking for one to two more intermediaries over the next four years. Those intermediaries invest in real estate operating companies all over the world, and put up their own capital in real estate transactions to assure an alignment of incentives, Bruebaker said.

Tangible assets, which WSIB began treating as a separate asset class in 2007, includes subcategories like energy, agriculture, minerals and mining. WSIB increased the target allocation for the class in order to build on relationships formed over the last ten years, while continuing to seek new partners, Bruebaker said.

### **Public equity cuts and staying focused**

With private equity, real estate, and tangible assets on the rise, something had to give. High public equity prices and concerns over a potential market downturn helped Washington decide to reduce public equity rather than fixed income, Bruebaker said.

"We had a lot of discussions here, and I'm talking months and months, about whether to take this money from fixed income or whether to take it from public equity, and during normal market cycles, I would have taken this money from fixed income," Bruebaker said. "WISB does not hold itself out as a market timer, but we do pay attention to trends, and this is the longest-running bull market that we've had in my lifetime. Trees don't grow to the sky."

WSIB's heavy commitment to private markets has been enabled by the board's long-term strategic focus, which hasn't wavered through the 2008 financial crisis or the public equity boom that followed, Bruebaker said.

"The single most important thing is the discipline to stick with it," Bruebaker said. "I've been here 16 years, but even longer than that, this board has not wavered from that direction."

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