The Regents of the University of California

COMMITTEE ON INVESTMENTS

January 19, 2000

The Committee on Investments met on the above date at UCSF-Laurel Heights, San Francisco.

Members present: Regents Atkinson, Bagley, Davies, Hopkinson, Lee, Moores, Nakashima, Parsky, and Taylor

In attendance: Regents Connerly, S. Johnson, Khachigian, Kozberg, Montoya, Pannor, Preuss, and Vining, Regents-designate Kohn and Miura, Faculty Representatives Coleman and Cowan, Secretary Trivette, General Counsel Holst, Treasurer Small, Assistant Treasurer Stanton, Provost King, Senior Vice President Kennedy, Vice Presidents Broome, Darling, Gurtner, and Hershman, Chancellors Berdahl, Carnesale, Cicerone, Dynes, Orbach, Tomlinson-Keasey, Vanderhoef, and Yang, and Recording Secretary Nietfeld

The meeting convened at 11:40 a.m. with Committee Chair Parsky presiding.

1. APPROVAL OF THE MINUTES OF THE PREVIOUS MEETING

The minutes of the meeting of November 18, 1999, having been distributed previously, were approved.

In response to a question from Regent Connerly, Secretary Trivette explained that traditionally only the minutes of the Board of Regents and the Committee on Investments have been submitted to the Regents for approval. She confirmed for Regent Hopkinson that the minutes for other Committees are not approved and offered to change this system.

Referring to the action taken in November to establish the Investment Advisory Committee, Regent Connerly expressed concern that it would function outside of the University's structure. Regent Parsky stressed that the Committee's function would be to advise the Committee on Investments.

2. ANNUAL ENDOWMENT INVESTMENT REPORT

In accordance with the Schedule of Reports approved by The Regents, the Treasurer presented the **Annual Endowment Investment Report** for Fiscal 1999. This fiscal-year report provides the Committee on Investments with information on The Regents' General Endowment Pool and the foundations' endowment investment returns, management fes, and asset allocations. In addition, the report outlines the expense and spending policies for The Regents' General Endowment Pool and each foundation. Investment performance is summarized in Sections III and X of the report.

Treasurer Small reported that, as of June 30, 1999, the University had approximately $5.8 billion of endowment assets, with $4.5 billion designated as Regents' assets and $1.3 billion in foundation assets. Overall, total endowment assets grew 16.3 percent, with The Regents' endowment assets growing 15.4 percent and foundation endowment assets growing 19.8 percent. Asset growth incorporates both new gifts accepted during the fiscal year and the return on total endowed assets. Seventy-eight percent of The Regents assets are restricted as to their use. The Treasurer explained that the annual endowment report focuses on the managed endowment assets held by The Regents and the foundations, which include those assets managed by The Regents (the Treasurer's Office) or external managers. Managed endowment assets do not include those assets categorized as "other endowment assets," such as separately invested assets, mortgages, real estate, and receivables.

Each foundation selects the investment manager(s) for their endowment assets. Their choices may include The Regents and/or external managers. Table 3 of the report displays the percentage of endowment assets managed by The Regents, external managers, the foundation itself, or "other," which are usually assets held separately at the donor's request. At June 30, 1999, the Office of the Treasurer managed most or all of the assets of the Davis, San Diego, Santa Cruz, and Santa Barbara campuses. Overall, the office manages approximately 26 percent of the foundations' endowment gift assets.

Turning to investment performance, Treasurer Small explained that virtually all endowment funds continued to capitalize on the bull market trends through June 1999 to register an overall weighted average return of 15.6 percent. This compares very favorably with the industry average of 10.7 percent and the industry median of 10.6 percent reported in the June 30, 1999 Cambridge Endowment Study. With respect to the allocation of managed funds by asset class, on June 30, 1999 the University's endowment assets had a weighted asset allocation of approximately 68 percent equities, 29 percent fixed income, and 3 percent cash.

With respect to investment management fees, the Treasurer reported that the overall weighted-average management investment fee for foundation assets was .39 percent, which compares favorably with the 65 basis points reported as the industry average in the 1998 NACUBO study performed by Cambridge Associates. Table 6 of the report provides gift fees and recurring charges by Regents and foundations. In March 1998, The Regents adopted a policy to allow the campuses to recover the reasonable and actual costs related to campus administration of Regents endowments, with the amount to be determined by historical cost data. As such, each campus collected endowment cost recovery fees on Regents gifts of anywhere from seven to 15 basis points of the 60-month rolling average market value of funds invested in the GEP. Several campuses also collect a recovery fee on foundation assets.

Treasurer Small reported that all of the foundations with the exception of Riverside have adopted a total return spending policy. The spending rates for fiscal 1999 range from 4.2 percent to 5.5 percent of a moving average market value.

Ms. Small stated that, as a result of the annual endowment investment report, the foundations have come to accept the report as valuable input both to the Regents and to the trustees. She continued that the trustees are all invited to visit the Office of the Treasurer and to learn how The Regents' investment philosophy is implemented.

Regent Hopkinson referred to the chart on page 13 of the report which tracked the performance of a $10,000 gift from 1990 to 1999. She asked that a line be added to show what the gift would be worth based solely on inflation.

2. **TREASURER'S OFFICE ANNUAL REVIEW OF INVESTMENT ACTIVITIES**

The Committee was informed that the Treasurer's Office has initiated an annual review as a means for the Regents to review the investment strategy and performance for the past year and to understand the Office's outlook for the markets and portfolios in the year ahead. This type of review, titled "Review of Activities, Treasurer of The Regents," was presented annually from 1980 until 1992, at which time it was no longer required by The Regents. However, given the growing complexity of the global markets, renewing this strategy piece will be useful.

Regent Parsky cautioned that comments by the Regents should be reserved for the Closed Session. General Counsel Holst confirmed that such an approach would be appropriate.

Treasurer Small called the Committee's attention to the excellent short-term returns on The Regents' funds in the past year, during which there were a difficult interest-rate environment, extreme valuations on selective market sectors, and an unprecedented narrow breadth in the markets. The UCRP and the General Endowment Pool total fund portfolios outperformed their benchmarks by 2.6 percent and 5.8 percent respectively. The common stocks beat the S&P 500 by approximately 3 percent. The venture capital partnerships returned between 340 and 400 percent, and the entire alternative equity category returned over 100 percent. These returns continue to build on the surplus in the retirement system and allow for enhanced distributions in the endowment funds. The bond portfolios basically matched their benchmarks, after years of wide outperformance. She noted the intention to discuss portfolio returns and characteristics in greater detail at the March meeting.

The Treasurer observed that the financial markets have just completed an unprecedented series of returns. The tremendous growth in The Regents' assets over the past few years suggests the need for serious discussion of how to preserve these gains. Some of the answers may be of a short-term strategic nature, while others may involve larger policy issues. Some of the major cornerstones of The Regents' investment philosophy are as follows. First and foremost is its focus on the importance of growing assets over a long time horizon rather than trying to capture short-term investment returns. This focus is true for both asset allocation decisions and individual security selection. It has allowed The Regents to identify and participate early on in important changes occurring in the world without succumbing to faddish or short-term strategies. The Regents' early entry into venture capital not only laid the foundation for future returns but also led to the crucial building of long-term relationships. The Regents has also maximized fixed-income total returns through diversification and reducing the reinvestment risk in a declining deflation environment.

Over the long term, asset allocation decisions are the most important factor in portfolio returns. The Regents was one of the first investors to realize the benefits of a higher allocation to equities as the best-performing asset over long periods of time. In 1958, The Regents mandated that the equity portion of the portfolios should not fall below 60 percent. The current policy of equities within a range of 60 to 75 percent, established in 1989, recognizes the long-term benefits of equities, while the flexible range allows for shorter-term cyclical economic considerations and relative value assumptions to drive the targets within their permissible ranges. The Office of the Treasurer has used this flexibility and has sold over-valued stocks, increased fixed income holdings, and expanded the number of common stock holdings from 65 to 85.

Treasurer Small explained that, over shorter and intermediate time frames, sector and group allocations are more important factors in performance. Flexibility within broad asset classes has served The Regents well. Rather than establishing static allocations to each subclass, The Regents' policy has enabled the Office of the Treasurer to invest more opportunistically in these assets only when they offered attractive relative values. Studies show that diversification for its own sake serves to dilute returns over the long term. If UCRP had been invested passively in a portfolio comprised of 50 percent in the S&P 500, 15 percent in EAFE,[1] 10 percent in the Russell 2000, and 25 percent in the Lehman Aggregate over the past ten years, its return would have been lower by 127 basis points per year. This translates to a difference of $5.2 billion over that time period.

Another cornerstone of The Regents' investment philosophy is a successful balance between a more aggressive allocation policy favoring equities and a conservative emphasis on overall portfolio quality. To offset the possible higher risk of such a strategy, The Regents' equity portfolios have always been of higher average quality than the S&P 500 in terms of value- line ratings and credit-risk measures. This emphasis exists in the fixed-income portfolios as well, which have averaged a rating of AA over their history.

Treasurer Small concluded her presentation by noting the Office's belief in relationships with corporations, counter-parties, and fund participants. She added that The Regents' success and

[1] Morgan Stanley Capital International Europe, Australasia, Far East Index

stability may be characterized by the words “flexible rigidity” because the basic elements of the investment philosophy have remained constant, while new strategies that make sense for the portfolios have been incorporated. All of The Regents’ policies and the Office of the Treasurer’s implementation of these policies have contributed to strong risk-adjusted returns over the years.

At the request of Committee Chair Parsky, Mr. Randy Wedding, Head of Fixed Income, informed the Committee that he had been with the Office of the Treasurer since June 1998. Prior to that he was employed by the Bank of America and by investment firms, including Morgan Stanley. He drew the Committee’s attention to the fixed-income section of the report, which predicts that thirty-year U.S. Treasury bond yields will range from 5.5 percent to 6.5 percent. Ten-year Treasury bonds are now at 6.75 percent, which is the highest rate to be reached during the bond-market sell-off which the Office undertook at the end of 1998. He noted that interest rates could be broken into real yield and inflation, which has implications for asset allocation. In mid-1997, the 6.75 percent yield was composed of a real yield of 3.75 and inflationary expectations of 3 percent. The real yield has risen to 4.40, while inflationary expectations have declined to 2.3 percent. The Office of the Treasurer correctly predicted inflation but was off with respect to yield structure. Real yields have risen due to the recent boom in the economy. Because the risk-reward profile for duration will be less attractive than it has been, the Office has reduced the duration of the fixed-income portfolios, moving toward the level of the Lehman Long-Term Gov/Corp, currently at 10.1 years.

At the request of Committee Chair Parsky, Mr. Jeffry Heil, Head of Equity Investments, stated that he had been with the Office of the Treasurer approximately two and one-half years. He came to the Office from Key Asset Management, where he was a vice president. Mr. Heil reported that the primary objective for the equity portfolio for the fourth quarter of 1999 and through 2000 is to trim some of the holdings that have experienced significant growth over the past few years in order to lower the high P/E risk. In selecting higher-quality, sustainable growth companies, the Treasurer’s Office uses a vigorous top-down analytic process to identify broad industry investment themes that should produce superior results over a multi-year horizon. The Office applies this analysis to build strategic, long-term positions with companies with excellent operating positions and solid management teams. Equity holdings total 84 names in the UCRP as of December, 31, 1999, and all sectors of the S&P 500 are represented. Approximately 34 percent of The Regents’ holdings revenues derive from foreign operations as contrasted with 30 percent in the S&P 500. More than 94 percent of the equity investments made in calendar 1999 represented new names for the portfolios. The five largest additions were McGraw Hill, Pharmacia & Upjohn, Masco, Apple Computer, and Nokia.

Beyond the bottom-up analysis of investing in quality companies with excellent management and assets, there are a few major investment themes in which many of these companies fit that should help increase share value over time. These include demographic changes, worldwide population growth, and retail consolidation. The performance that stemmed from these activities over the past year was very good, with the common stock investments appreciating by 23.5 percent. With respect to market outlook, Mr. Heil reported that he anticipates a moderation of domestic growth and an acceleration of overseas growth. The sale of some holdings will lock in recent years' gains and lower the valuation risk. The Office plans to maintain its core philosophy of growth at a reasonable price. There will be a strong commitment to technology and the telecommunications sectors and a continuation of the increase in the portfolios' exposure to foreign securities from 7 to 10 percent of total assets. The Treasurer's Office will continue to emphasize the portfolios' small-cap exposure primarily through the private equity distribution area. The portfolios' participation in private equity, largely through the post-distribution funds managed by Warburg, Pincus, along with the broad exposure to venture capital and other private equity investments, is the best strategy for continued exposure to the small-cap segment, given the proven expertise of the general partners in this area.

Mr. Kenneth Wisdom, Private Equity Officer, explained that prior to joining the Treasurer's Office in 1999 he was the Senior Investment Analyst in Alternative Investments for the Commonwealth of Massachusetts' pension fund. As discussed in the report, the philosophy of the alternative investments program is to create value through investing in long-term growth vehicles with an emphasis on quality of management and strong performance. The long-term strategic objective of The Regents' alternative investments program is to develop and maintain an adequate exposure to select alternative investments, generate an attractive long-term rate of return in comparison to appropriate market indices, develop and maintain an adequately diversified alternative investment portfolio, and reduce the risk of the overall Regents' portfolio through added diversification. The Regents' alternative investments program is made up of the following categories: private equity, including venture capital, buyout, and international partnerships; and other public equity, including emerging market net asset value funds and a post-venture, small cap fund. The rationale for The Regents' participation in private equity is multi-faceted:

Attractive Returns: Private equity provides attractive, risk-adjusted returns. Investors in private equity expect a risk premium for holding illiquid securities over long time periods.

ReducedRisk: Due to its low correlation with other asset classes, private equity provides diversification and reduced risk to the overall portfolio when introduced to an asset allocation.

Value-Added Investing: Private equity managers have the ability to add value by influencing management, negotiating transactions and influencing liquidity options. In private markets, there is less information available than in public markets, leading to more opportunities to exploit the inefficiencies.

To date, The Regents has committed approximately $1.55 billion to 77 private equity funds across 19 different private equity managers. To date, $1.18 billion of these commitments have been drawn down, and the portfolio has returned $1.3 billion in distributions back to The Regents, with $1.2 billion in remaining value. Over the past twelve months, the program has generated returns in excess of 100 percent, led by venture capital investments, which have returned over 300 percent.

The Treasurer's Office began its current private equity program in 1979, initially emphasizing investment in established West Coast venture capital funds that primarily made early-stage investments in technology. Prior to 1979, The Regents invested directly in a number of private equity companies. The Regents' participation in venture capital recognizes the importance of technology industries to the State of California, the unique position the University holds within the state, and the University's unique contributions to and benefits derived from these industries. As one of the first investors in Silicon Valley, the Treasurer's Office has formed long-standing relationships with the premier venture capital groups and has built a reputation as an active and sophisticated partner.

The Regents' private equity vintage year returns have exceeded Cambridge Associates' median returns in every vintage-year since inception, and The Regents' performance has exceeded Cambridge Associates' upper quartile returns in five of the past eight years.

With the consistent increase of private equity investment realizations and a roaring bull market in the stock averages, The Regents has received a significant amount of stock distributions. In 1996, the Treasurer's Office received approval from The Regents to hire Warburg, Pincus as a post-venture distribution manager to manage effectively these distributions, balancing the goal of enhancing venture returns while at the same time achieving liquidity. This portfolio of small-cap stocks provides The Regents' with exposure to, as well as cutting edge information on, technology and Internet public equities. Some of The Regents' holdings that have performed extremely well are Intuit, Yahoo, Excite, @Home, BroadVision, Amazon.com, and Redback Networks.

In 1998, the Treasurer's Office, at The Regents' request, retained Cambridge Associates to perform a two-phase review of the private equity program. In phase one, Cambridge Associates concluded that the Treasurer's Office has executed one of the most successful private equity programs during the past twenty years. Cambridge Associates also noted that the allocation of less than 3 percent of The Regents' portfolios to private equity is much smaller than various peer groups and is too small to have a material impact on either total fund returns or diversification. Cambridge Associates, therefore, suggested a 5 percent allocation. In phase two of the review, which has not been presented to The Regents, Cambridge Associates reviewed process issues and further recommended the expansion of the current investment program to include a broader range of venture strategies, as well as domestic and international buy-outs. As a result, Cambridge Associates supported the current private equity process being used by the Treasurer's Office and recommended further developing the internal resources dedicated to making private equity investments. Given the uniquely successful private equity program of The Regents, fostering internal staff and resources would provide the greatest alignment of interest in managing a private equity

portfolio. Most of the long-term private equity investors advise that controlling the process and the relationships directly are important. To rely on external resources would require the sacrifice of the deep relationships that are essential to the long-term success of the portfolio.
Mr. Wedding discussed the risk management section of the report. As noted in the report, a sound risk management program involves identification of portfolio risk, as well as its quantification, and modification through appropriate structures. In prior years, the Treasurer's Office approached its risk management through stress testing and scenario analyses on the risks and returns. However, the Office lacked the ability to perform such analyses on a portfolio-wide basis. As a result, the Treasurer's Office recently undertook a study to improve systems infrastructure for efficient measurement and management of aggregate portfolio risk. As part of this exercise, several soft-ware vendors were invited to make presentations and demonstrate their systems' capabilities. After evaluating qualified systems, the Treasurer's Office chose to implement the Bloomberg Portfolio and Trading System. This system performs the following portfolio management functions: analytics, scenario and stress testing, report writing, and order and ticket management. Having identified and quantified a risk, the Office has traditionally undertaken a transaction in the stock or the bond market to alter the exposure. The Office would like to have the ability to use some derivative instruments to alter the exposure in a more expeditious fashion, such as futures and options on futures.

Treasurer Small pointed out that the annual review provides brief biographical statements for professional staff in the Office of the Treasurer. She recalled that one reason she had asked for the Regents' involvement in the budget process was a concern that the University would not be able to offer competitive salaries in the investment arena. The former budget process had not provided what the Office needs in terms of Regental oversight and sensitivity to issues. She stated that she was more comfortable today than she was ten years ago with the breadth and the depth of her staff.

Regent Parsky noted that it was important as the Committee moves toward an evaluation of the asset allocation plan that the Regents understand fully the experience level, the tenure, and the understanding that the staff has with respect to the assets under management. Of the 30 staff members who are listed in the annual report, with the exception of the three most senior members, 15 have joined the Office within the past two years. Mr. Parsky observed that the Treasurer is investing in the private equity area without being specifically authorized to do so by The Regents. The office tenure of an individual making these investment decisions is an important consideration before The Regents delegate the ability to invest 5 percent of the portfolio without outside consultation.

The meeting adjourned at 12:35 p.m.

Attest:

Secretary