The Regents of the University of California

COMMITTEE ON INVESTMENTS

September 14, 2000

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

Members present: Regents Atkinson, Bagley, Davies, Hopkinson, S. Johnson, Leach, and Miura

In attendance: Regents Connerly, Fong, Khachigian, Kohn, Lansing, Lee, Montoya, Preuss, and Sayles, Regents-designate T. Davis, Morrison, and Seymour, Faculty Representatives Cowan and Viswanathan, Secretary Trivette, General Counsel Holst, Provost King, Senior Vice Presidents Darling and Mullinix, Vice Presidents Broome and Hershman, Chancellors Berdahl, Bishop, Carnesale, Cicerone, Dynes, Greenwood, Tomlinson-Keasey, and Vanderhoef, and Recording Secretary Nietfeld

The meeting convened at 10:50 a.m. with Committee Chair Hopkinson presiding.

1. APPROVAL OF MINUTES OF PREVIOUS MEETINGS

Upon motion duly made and seconded, the minutes of the meetings of May18, 2000 and July 20, 2000 were approved.

2. SELECTION OF INDEX INVESTMENT MANAGER

It was recommended that, following presentations by the two proposing firms and consideration of the conclusions of the evaluating team, the Committee on Investments recommend to The Regents the selection of the University's Index Fund Manager.

Mr. Steve Nesbitt of Wilshire Associates informed the Committee that the firms of Barclays Global Investors (BGI) and State Street Global Advisors (SSgA) would present their proposals to manage The Regents' Russell 3000 Index Fund and MSCI EAFE Index Fund. Together these investments will total approximately $12 billion.

The firm of Barclays Global Investors was represented by the following staff members:

John Martinez, Co-Chief Executive Director, Global Index & Markets Group
Francis Enderle, Chief Investment Officer
Judith Robertson, Global Securities Lending Manager
David Rothenberg, U.S. Head of Barclays Global Investor Services and Transition Services
Peter V. Landin, Head of Client Relationship

Julie Boggs, Chief Relationship Officer, Team Leader
Fernando Hernandez, Business Development Officer

Mr. Martinez described the scope and scale of BGI's capabilities in investment management, noting that the firm is the world's largest index manager, with $826 billion under management for over 1,600 clients. Of particular relevance to The Regents, BGI manages $64 billion in Russell-based index strategies and $89 billion in MSCI-based index strategies. Through the use of slides, Mr. Martinez presented relevant statistics regarding the firm and its approach to index management. The size and diversity of its client base create transaction cost savings through crossing opportunities. For example, in 1999 96.2 percent of the Russell 1000 Index Fund was traded internally. Cost savings from crossing can exceed years of investment management fees. Mr. Martinez briefly described BGI's transition services and its securities lending services, noting that the coordination between portfolio management, trading, and securities lending creates high returns for its clients. A focus on risk management in securities lending has led to BGI's record of no client losses in the history of the program. In closing Mr. Martinez stressed that BGI's strategy of total performance management would be of great benefit to The Regents.

In response to a question from Regent Hopkinson regarding client support, Mr. Landin explained that Ms. Boggs would be the relationship officer assigned to The Regents. Her team is responsible for approximately $80 million under management, and her accounts include the State of New York.

Regent Leach asked for comment on whether The Regents would be better served by a separate or a co-mingled account. Mr. Martinez noted that BGI had proposed two options for The Regents' accounts. Under the first proposed structure, the University of California Retirement Plan (UCRP), the General Endowment Pool (GEP), and the 403(b) equity fund would participate in a Custom Russell 3000 Index Fund "B" and a Custom MSCI EAFE Index Fund "B" which would initially be established for The Regents. Each plan would have identical performance across the investment strategies. Under the second option, the retirement plan would participate in the "A" series of co-mingled funds, and the GEP and 403(b) equity fund would participate in the currently-existing "B" funds. The benefits of the second option include greater opportunities for cost savings through crossing, lower administrative costs, and lower management fees. Mr. Martinez assured the Committee that BGI would be able to create tobacco-free co-mingled index funds for the same management fee. He recalled that BGI had recommended the co-mingled fund structure to the Investment Advisory Committee. Mr. Enderle observed that a larger, co-mingled index fund generally performs better than a separate account with limited assets. He noted, however, that given the size of The Regents' portfolio, it should be possible to achieve similar returns with a separate account.

Regent Leach asked what level of return The Regents might expect from securities lending. Ms. Boggs reported that BGI's proposal for the EAFE portfolio would have returned 9.5 basis points, net of all fees. This would equal approximately $3 million annually. The return for the Russell 3000 would have been 2.7 basis points net of fees.

(At this point, the representatives of Barclays Global Investors left the meeting, and the representatives of State Street Global Advisors entered the meeting.)

Mr. Nesbitt recalled that State Street Global Advisors had provided custody services and securities lending services to The Regents since 1994. SSgA was represented by the following staff members:

David A. Spina, President and Chief Executive Officer of State Street Corporation
Brad J. Hilsabeck, Principal
Peter G. Leahy, Principal
Susan C. Raynes, Principal

Mr. Spina noted that SSgA values its existing relationship with the University of California and is eager to build on this relationship through the provision of index fund management for The Regents' portfolios. Mr. Leahy highlighted some of the strengths of SSgA, including the experience of the staff and the size of the assets under management. The firm is one of the largest U.S. index managers and the largest manager of non-U.S. indexed assets, which allows it to pass along cost savings to its clients. SSgA accommodates the objectives of a diverse client base with customized products and solutions. State Street has over 800 index equity clients tracking approximately 50 benchmarks. It averaged over $10 billion in index fund trading volume per month in 1999, which resulted in high crossing percentages. The estimated cost savings for clients from the crossing of $106 billion was almost $500 million in transaction costs.

Mr. Hilsabeck presented the recommendation that The Regents invest in a unitized separate account, noting that among the advantages to this approach are lower total costs, greater flexibility, and consistency of performance for UCRP, GEP, and (403)b plan assets. In addition, State Street provides an 80/20 securities lending split to The Regents, which will more than offset fees for custody and investment management. With a separate account, there will be the ability to eliminate stocks such as tobacco from The Regents' index funds. There will also be flexibility with respect to proxy voting.

Regent Leach asked what level of annual earnings could be expected from securities lending based on SSgA's historic performance. Mr. Leahy estimated that, before the split, it would be on the level of 3 to 4 basis points on the Russell 3000 index fund and 15 to 20 basis points for the EAFE index fund.

Reach Leach referred to a newspaper article which discussed Mr. Spina's intention to bring "new life" to the State Street Corporation and asked what these changes might imply for the clients. Mr.

Spina explained that they are designed to respond to the evolving nature of the business, which is changing from selling individual products to clients to selling groups of services. This creates the necessity for specialized members of the firm such as accountants to work closely with its experts in index management to provide the highest level of service to its clients.

At the request of Regent Hopkinson, Mr. Hilsabeck described the client management structure which SSgA would provide to The Regents. Ms. Raynes, the senior client service officer, will be the primary point of contact for the University. The management team will also be accessible to The Regents. Ms. Raynes continued that she and her staff would serve as The Regents' advocate within the organization to ensure that the full resources of SSgA are brought to bear on the accounts.

In response to a question from Regent Hopkinson, Mr. Hilsabeck stated that he would not anticipate any difference in returns for a unitized as opposed to a co-mingled account.

Regent Bagley observed that State Street has a large percentage of non-U.S. funds under management and asked whether this posed currency risks. Mr. Leahy responded that the clients who wish to invest in these markets are willing to take currency risks to receive high rates of return. Some clients hedge their funds in order to mitigate currency risk.

(At this point, the representatives of State Street Global Advisors left the meeting.)

Committee Chair Hopkinson pointed out that State Street Global Advisors was the unanimous choice of the evaluating team.

Mr. Jeff Heil, Head of Equity Investment, introduced the Committee's discussion of the selection by noting that the Office of the Treasurer had a strong preference for the establishment of separate accounts for The Regents' index funds. State Street's proposal is therefore much stronger than BGI's in terms of its approach and account structure. Regent Hopkinson drew the Committee's attention to the fee comparison in the report of the evaluating team.

Mr. Nesbitt referred to questions which were raised by the Committee during the presentation. He reported that it was the opinion of both the Treasurer's Office and Wilshire Associates that there should be no difference in performance between a co-mingled and a separate account structure. He recalled that BGI had stressed that transition costs would be lower for a co-mingled account. Neither State Street, Wilshire Associates, nor the Office of the Treasurer agrees with this approach. In reference to Regent Leach's questions regarding securities lending, Mr. Nesbitt estimated that securities lending income would be $6,695,000 under management by State Street and $4.8 million under management by BGI. This difference tips the financial assessment of the proposals in favor of SSgA. Mr. Heil added that investors are more interested in the types of stocks which are represented in the EAFE index, which will drive the increase in securities lending income.

Regent Preuss asked if there were any difference between the two firms with respect to potential financial loss for the University. Mr. Nesbitt noted that Barclays Global Investors and State Street Global Advisors are the two largest index managers in the world. He referred to both firms' records of exemplary performance.

General Counsel Holst discussed the proposed contract which would hold the chosen firm liable in the case of errors. Each firm has received the University's consulting agreement, with its standard indemnification provisions. Neither firm voiced objections to the terms of the agreement.

Mr. Nesbitt continued that the firm would accept responsibility for any clerical or administrative mistakes. There is no guarantee that the performance of the portfolio will match the index. Their history strongly suggests that the performance will be within a few basis points of the index performance. He confirmed for Regent Preuss that there is no difference between the two firms with respect to this issue.

In response to a question from Regent Connerly regarding the reaction of the Office of the Treasurer to the implementation of an index fund, Mr. Heil stated that he was comfortable with The Regents' asset allocation decision to move a portion of the portfolios to an index fund. He confirmed for Regent Connerly that such a move would be in the best interests of the University if it remains at its present level of 30 percent of the portfolios.

Regent S. Johnson referred to the guidelines to investment committees issued by the Association of Governing Boards, which recommend that trustees seek outside advice as a prudent way to manage funds.

Regent Hopkinson reported that it was the conclusion of the Investment Advisory Committee that Barclays and State Street were both competent firms. The Regents' decision should be based upon the desire to have a separate account and upon the fee structure. The advisory committee supported the choice of SSgA.

(For speakers' comments, see the minutes of the September 14, 2000 meeting of the Committee of the Whole.)

Upon motion of President Atkinson, duly seconded, the Committee voted to recommend to the Board that State Street Global Advisors be chosen as The Regents' Index Fund Manager.

[The report of the evaluating team was mailed to all Regents in advance of the meeting, and a copy is on file in the Office of the Secretary.]

3. **AUTHORIZATION TO EXECUTE CERTAIN AGREEMENTS FOR INVESTMENT PROCESSING AND RESEARCH THAT CONTAIN INDEMNIFICATION LANGUAGE REQUIRING ASSUMPTION OF THIRD-PARTY LIABILITY**

The President recommended that he and his delegatees, after consultation with the Office of General Counsel, be authorized to enter into agreements with real time data providers and analytical and trade processing systems providers, notwithstanding the fact that such agreements may require the University to indemnify, defend, and hold the providers harmless from claims of third parties.

The Committee was informed that, in order for the Office of the Treasurer to conduct routine investment processing and research, it must sometimes enter into agreements with single source providers for such services. These agreements often contain indemnification language that requires the University to indemnify, defend, and hold the provider harmless from claims which may be brought by third parties as a result of the operation of the agreement.

Standing Order 100.4(dd)(9) requires Regental approval and authorization for the President to enter into such agreements when the assumption of such liability is for other than University officers, agents, employees, students, invitees, and guests. Although these contracts present little risk, the Office of the Treasurer is often unable to have the service providers modify their standard third-party indemnification language. The vendors have little incentive to negotiate the contract language as the Treasurer is one of many clients, the payment for these services is relatively small, and they are often the sole source for the service.

Over the years, a number of proposed agreements have not been entered into by the Office of the Treasurer due to the service providers' inflexibility in accommodating the request to modify their contract language. In order to take advantage of state-of-the-art technology and timely data feeds used within the investment profession, especially by sole providers, the Office of the Treasurer has requested a waiver of Standing Order 100.4(dd)(9), with respect to agreements with real-time data providers and analytical and trade processing systems.

The following agreements have not been executed due to service providers' indemnification provisions, and these vendors have refused to alter their agreements to be in compliance with The Regents' liability restrictions:

- Salomon Analytics Yield Book: necessary to produce fixed-income performance attribution and monitor benchmark risk relative to benchmarks.

- Bloomberg: an existing service in the Office of the Treasurer. This provider offers an automated front-end processing of trades into the University's investment accounting system.
- NASDAQ: real-time quote service.
- NYSE: real-time quote service.

The liability associated with the above services represents little if any liability risk to The Regents in connection with the possible claims brought against the provider. All but Bloomberg are normal information research and quote providers. The Bloomberg service will allow for the electronic interface of trade information into the University’s investment accounting system.

Approval of the recommendation will grant the President the authority to approve such contracts. As a matter of process, the Office of General Counsel will review all such agreements in order to suggest terms to minimize the University's risk exposure.

Upon motion duly made and seconded, the Committee approved the President’s recommendation and voted to present it to the Board.

4. UPDATE ON ASSET ALLOCATION PLAN IMPLEMENTATION

Ms. Linda Fried, Fixed Income Manager, recalled that at the July meeting the Treasurer’s Office presented the Committee with a detailed transition plan for bringing The Regents’ portfolios into compliance with the new asset allocation targets and portfolio guidelines by December 31, 2000. The transition involves four main areas being worked on by the Office of the Treasurer, the Office of The President, and Wilshire Associates. The first involved the selection of the fund manager for the Russell 3000 Index Fund and the EAFE Index Fund. The second area involves adjusting the portfolios to meet the new asset allocation targets, while the third will bring the retirement and endowment funds into compliance with the new policies and guidelines. The fourth part of the transition plan is liquidating and/or crossing a portion of equity holdings to fund the Russell 3000 and EAFE index funds.

Ms. Fried reported that the transition is proceeding on schedule, and all funds are currently in compliance with the majority of both the new asset allocation targets and the individual portfolio guidelines. Full compliance is on track for December 31, 2000, with the exception of the June 20, 2001 extension for reducing the duration of the bond portfolios requested by The Treasurer’s Office and granted by The Regents.

Regarding asset allocation, The Regents’ portfolios are in compliance with almost all areas of the new guidelines. The one exception is the non-U.S. equity portion, which was awaiting the selection of the Morgan Stanley EAFE index fund manager. With the selection of the manager at today’s meeting, completion is anticipated by the end of October. The projected total dollar amount to be invested in the EAFE Index Fund for the UCRP, GEP, and the 403(b) equity funds is currently estimated to be $3.4 billion. Once funded, both the U.S. and non-U.S. equity portions of each fund will be in compliance.

Mr. Heil explained that the main area affecting equities is the funding of the Russell 3000 index fund. The projected total dollar amount that will be invested in the Russell 3000 Index Fund for the UCRP, GEP, and 403(b) equity funds is approximately $8.6 billion. In anticipation of this process, the equity group in the Treasurer's Office has been formulating strategic industry and individual asset weightings for the portfolios and recommending sales from and additions to existing positions. These are currently being effected so that the resulting net positions after a pro-rata reduction to fund the Index portions of the portfolios are made will reflect the desired portfolio weightings versus the new benchmark Russell 3000 weightings. It is expected that, depending on market conditions, this will be fully completed by October 31, 2000. The Regents' private equity portfolio is largely in compliance with the investment guidelines.

The primary area of transition pertains to achieving a long-term target allocation of 5 percent in private equity. The UCRP, which has the smallest current percentage of private equity, will be allocated the majority of all future commitments to private equity partnerships. The endowment pool has flexibility within the guidelines to continue a slightly reduced allocation to new investments. The equity fund, which has the largest percentage allocation to private equity, will receive a minimal allocation going forward.

Mr. Randy Wedding, Head of Fixed Income, reported that the fixed income portfolios are in compliance with the majority of the new portfolio guidelines, and the Office is in the process of reducing certain positions to satisfy the remaining guidelines. All of the fixed income guidelines will be in compliance by the December 31 target date with the exception of duration, which will be in compliance by June 30, 2001.

Following a comment by Regent Lee, Mr. Heil stated the Investment Advisory Committee would routinely review performance versus expenses for the externally managed and the internally managed portfolios. Regent Lee requested that such data be provided to the Regents.

5. **REPORT OF THE INVESTMENT ADVISORY COMMITTEE**

Regent Hopkinson reported that the Investment Advisory Committee, at its first meeting, heard presentations from the two firms which were under consideration as index fund managers. The committee will consider the selection of the private equity consultant at its meeting in October.

The meeting adjourned at 12:10 p.m.

Attest:

Secretary