The Regents of the University of California

COMMITTEE ON INVESTMENTS
March 14, 2001

The Committee on Investments met on the above date at the James E. West Alumni Center, Los Angeles campus.

Members present: Regents Atkinson, Bagley, Davies, Hopkinson, S. Johnson, Marcus, Miura, Moores, and Parsky; Advisory member T. Davis

In attendance: Regents Connerly, Fong, O. Johnson, Kohn, Kozberg, Lansing, Lee, Montoya, Preuss, and Sayles, Regents-designate Morrison and Seymour, Faculty Representatives Cowan and Viswanathan, Secretary Trivette, General Counsel Holst, Interim Treasurer Bowman, Assistant Treasurer Stanton, Provost King, Senior Vice President Mullinix, Vice Presidents Broome, Drake, Gomes, and Gurtner, Chancellors Bishop, Cicerone, Dynes, Orbach, Vanderhoef, and Yang, Executive Vice Chancellor Simpson representing Chancellor Greenwood, and Recording Secretary Nietfeld

The meeting convened at 10:05 a.m. with Committee Chair Hopkinson presiding.

1. **APPROVAL OF MINUTES OF PREVIOUS MEETING**

Upon motion duly made and seconded, the minutes of the meeting of January 17, 2001 were approved.

2. **APPOINTMENT OF INVESTMENT CONSULTANT**

It was recommended that, following presentations by two proposing firms, Watson Wyatt Investment Consulting and Wilshire Associates Incorporated and consideration of the recommendations of the review panel, the Officers of The Regents be authorized to execute an agreement with one of these firms to serve as the University's general consultant in connection with the ongoing review of the University of California's investment program. The consultant services will be conducted for a term of three years.

It was recalled that the investment funds managed by the Office of the Treasurer consist of the University's retirement, defined contribution, and endowment funds, as well as the system's cash assets. The investment portfolio currently has approximately $58 billion in total assets.

At its meeting of May 18, 2000, The Regents approved a recommendation to execute an agreement with Wilshire Associates Incorporated for general consultant services in connection with implementation of the asset allocation plan adopted by The Regents in March 2000 for a term of one year at a fee of $350,000. The University's contract with Wilshire Associates expires on March 31, 2001. The asset allocation plan calls for the continued retention of a general consultant, reporting to the Investment Advisory Committee and The Regents, to provide ongoing advice on asset allocation, investment policy, manager selection/termination, performance measurement, and reporting. The general consultant would also assist in implementing the recommendations in the asset allocation plan.

On January 17, 2001 the Committee discussed a Request for Proposals (RFP) for consulting services to conduct a review of the investment program. As outlined in January, the general consultant would be responsible for the following scope of services:

- Periodic (at least annual) evaluations of The Regents' asset allocation plan, with consideration of market conditions, manager performance, the financial condition of the individual funds under management, risk tolerance and other relevant considerations, such as cash flow requirements and overall plan liability.

- The appropriateness of the investment benchmarks which are being used to assess investment performance and the review of investment performance against appropriate benchmarks, including the investment performance for each asset class.

- A quarterly evaluation of the performance of the funds managed by the Treasurer, including an executive summary and a detailed analytical review of the investment portfolios.

- Assistance and recommendations in the periodic review and development of investment policies, procedures, and investment guidelines to document and enhance the management of funds. Evaluation of investment performance objectives and limits on investment risk for the stock and bond portfolios.

- Analysis of the performance of the University's index fund managers and recommendations for changes as deemed by the consultant to be appropriate.

- Analysis of the performance of the private equity consultant and function on an annual basis.

- Specialized studies and reports on specific investment matters.

- Reports on campus foundation investment policies and performance.

Following this discussion, the University issued the RFP to nine firms with known interest and expertise in investment consulting and advertised in a leading publication for RFP advertisements in the industry. Fifteen additional firms were sent the RFP based on their response to the advertisement. Questions were entertained, and supplemental information responding to these inquiries was provided to all firms. By the deadline of February 16, 2001, the University received formal proposals from the following three firms: Canterbury Consulting, Watson Wyatt Investment Consulting, and Wilshire Associates Incorporated.

A review panel comprised of Mr. Russell Gould, a member of the Investment Advisory Committee, Professor Bruce Lehmann, consultant to the advisory committee, Senior Vice President Mullinix, and Vice President Broome reviewed the three proposals. The review panel concluded that two of the firms were well qualified to provide the requested services. These two firms, Wilshire Associates Incorporated and Watson Wyatt Investment Consulting, were invited to make a presentation to the review panel on February 26, 2001.

On March 1, 2001, the members of the review panel met and shared their ratings of the two firms. The firms were rated based on the overall depth and competency of the firm, the overall depth and competency of the principal staff proposed to be assigned to the project, the proposed plan of work, and other criteria including potential conflicts of interest and the fee proposal. Each of the criteria carried a weighting of 25 percent.

Committee Chair Hopkinson invited Mr. Jim Van Heuit, Senior Consultant for Watson Wyatt Investment Consulting, to make his presentation. Mr. Van Heuit noted that one objective of Watson Wyatt as The Regents' consultant would be to protect the University's investments. In addition, it is important to earn the highest level of return with the lowest corresponding risk. The Regents must accommodate an increasing number of retirement plan participants as the workforce grows in response to increased enrollment demands. Turning to the consulting services to be provided by Watson Wyatt, Mr. Van Heuit noted that asset allocation is a crucial function of the investment program. The firm's strengths include experience with multi-billion dollar retirement plans, including General Electric, IBM, and the Virginia State Employees Association. Mr. Van Heuit reported his personal involvement with the New York State Common Retirement Fund and the Teachers Retirement System of Texas, a plan comparable in size to the University of California Retirement Plan. This experience translates into a common-sense approach to establishing The Regents' asset allocation plan. Watson Wyatt is affiliated with an actuarial firm to ensure that retirement liabilities are accurately incorporated in the asset allocation model. The firm has had a full academic review of its asset allocation methodology by a panel of experts, including a member of the University of California faculty. The panel found that Watson Wyatt is using best practices in establishing its asset allocation. Mr. Van Heuit suggested that the selection of an investment consultant should be based on how well the firm monitors The Regents' investment program. Watson Wyatt is available to The Regents as an independent resource which manages no investment funds. The firm has no vested interest in The Regents' investment program nor in the benchmarks used to measure the performance of the program. Watson Wyatt would subject The Regents' internal fund management to the same scrutiny it applies to external managers. As The

Regents' consultant, the firm would analyze the performance of the portfolios and verify that this performance was based upon the approach of the investment manager.

Regent Hopkinson asked for information about clients with portfolios similar to those of The Regents. Mr. Van Heuit reported that the firm's largest client is Qwest Communications, which has a $25 billion portfolio. He confirmed for Regent Hopkinson that large pension funds are clients of the firm's San Francisco office.

In response to a question from Regent Parsky, Mr. Van Heuit explained that Watson Wyatt is primarily involved in General Electric's asset allocation, as well as providing assistance in evaluating investment managers and investment policies. The firm provides a full range of services for the Virginia State Employees Association. These services include asset allocation, establishing investments policies, selecting investment managers, and evaluating performance.

(At this point, Mr. Van Heuit left the meeting, and the representatives of Wilshire Associates entered the meeting.)

At Committee Chair Hopkinson's request, Mr. Steve Nesbitt, Senior Managing Director at Wilshire Associates, introduced the members of his team: Mr. Dennis Sugino, Managing Director; and Ms. Kathy Barchick, Vice President. To begin his presentation, Mr. Nesbitt outlined some of the qualities of Wilshire Associates that make it a good fit for The Regents. Wilshire is the largest pension and endowment consulting firm in the country. It is stable and well capitalized. The firm is 100 percent employee-owned, with a significant fraction of each employee's net worth tied to the company. Wilshire Associates focuses on large pension and endowment funds, with an average size that exceeds $8 billion. It has a global presence, with over three hundred employees in seven offices. Mr. Nesbitt noted that the firm's most prized assets are its consultants, most of whom have years of experience at Wilshire Associates.

Mr. Nesbitt then turned to accomplishments over the past year, some of which had been undertaken with the Office of the President, the Office of the Treasurer, the Committee on Investments, or the Investment Advisory Committee. The most important accomplishment was the asset allocation study, which put into place a long-term investment strategy which will be followed over the years to come. The investment policy and guidelines were rewritten to provide better control over management and to control risk in the portfolio. Wilshire participated in the search for an index fund manager which resulted in the selection of State Street Global Advisors. During the fourth quarter the firm assisted in the transition of $11 billion from existing portfolios to the Russell 3000 and the MSCI EAFE index funds. In addition, Wilshire has worked with Towers Perrin, The Regents' consulting actuary, and the Academic Senate's Committee on Faculty Welfare on an asset/liability study. The firm has participated with the Investment Advisory Committee in its beginning dialogue with the campus foundations. Other activities included assistance with the development of a budget for the Office of the Treasurer, quarterly performance reporting, and independent return calculations.

Mr. Nesbitt commented that Wilshire Associates is fully prepared to carry out the eight consulting responsibilities that were listed in the RFP, and he emphasized a number of these consulting priorities. The first will be an ongoing assessment of campus foundation performance, including encouraging the foundations to work more closely with the Office of the Treasurer. The firm expects to make recommendations to The Regents concerning oversight of the foundations. Another goal will be to assist in building a first-class staff within the Treasurer's Office. Wilshire will work to present a more sophisticated analysis of performance attribution. It will review the performance of emerging market managers. Finally, there will be a review of the asset allocation study to determine whether there should be separate investment policies for the retirement plan and the general endowment fund.

(At this point, the representatives of Wilshire Associates left the meeting.)

Regent Hopkinson reported that the review panel had been unanimous in recommending that Wilshire Associates be chosen as The Regents' general investment consultant. Wilshire was found to be superior in each of the four selection criteria. With respect to the fee structure, Wilshire has proposed $425,000 for year one of the contract, $450,000 for year two, and $475,000 for year three. The proposed Watson Wyatt fee structure, while initially lower, does not include five of the six projects described by Mr. Nesbitt. She estimated that, taken at an hourly rate, Watson Wyatt would spend only twenty hours per month on the engagement before it exceeded the fee proposed by Wilshire. Regent Hopkinson stated her support for the review panel's recommendation to select Wilshire Associates Incorporated.

In response to a question from Regent Lee, Regent Hopkinson reported that Watson Wyatt's fees would be in the range of $200 to $550 per hour, with Mr. Van Heuit the primary consultant at the $550 rate. She stressed the involvement of Wilshire Associates in many important ongoing projects and that the $425,000 fee proposed by Wilshire is all-inclusive.

Regent Davies observed that the Regents may be criticized for continuing to retain Wilshire Associates and asked for an explanation of why only three firms submitted proposals in response to the RFP. Senior Vice President Mullinix noted that Wilshire Associates is the market leader in this field and that all of the respondents to the RFP were aware that the firm intended to compete for the contract. Typically with consultant relationships there is a tendency to retain a firm that provides satisfactory service. Regent Davies commented that, while he was not dissatisfied by the work being performed by Wilshire, he believed that it was to the University's advantage to change consultants from time to time.

Regent Parsky pointed out that the nature of the work to be performed by the investment consultant limits the number of firms that are qualified to compete. Regent Hopkinson continued that, although the University had entered into a series of contracts with Wilshire, it was only during the past year that the firm had engaged in the ongoing activities that will constitute the proposed engagement. The University's requirements with respect to conflicts of interest also limit the responses. She noted that the review panel had consistently ranked Wilshire above Watson Wyatt on the selection criteria.

Regent Davies continued to express concern that Wilshire Associates should not be seen as an automatic choice by The Regents. He urged the administration to attempt to ensure a larger pool of candidates when the present three-year contract expires.

Regent Lansing concurred with Regent Davies' concerns and asked about satisfaction with Wilshire's performance. Regent Hopkinson believed that the quarterly investment report would illustrate how well the Office of the Treasurer, in consultation with Wilshire, had performed given the state of the stock market. In response to a further comment by Regent Lansing regarding the length of the contract, Committee Chair Hopkinson pointed out that it will have a thirty-day cancellation clause.

Regent Parsky continued to emphasize the nature of the work to be performed by The Regents' general investment consultant. The firm is not being retained to manage The Regents' portfolios but rather to monitor it. Many consultants avoid this type of work due to conflicts of interest. Regent Hopkinson pointed out that Wilshire Associates was not eligible to compete as The Regents' private equity consultants.

Regent Connerly shared some of the concerns voiced by Regents Davies and Lansing. Given the performance of Wilshire Associates, however, he supported the recommendation.
Regent Lee suggested that retention of the investment consultant be delayed until a permanent Treasurer has been appointed. Regent Hopkinson stressed that Wilshire Associates had formed a positive working relationship with the Office of the Treasurer. It will be helpful to the new Treasurer to have this relationship already established. The contract allows The Regents to terminate the contract if the need should arise.

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

The meeting adjourned at 10:45 a.m.

Attest:

Secretary