COMMITTEE ON INVESTMENTS
May 15, 2002

The Committee on Investments met on the above date at Covel Commons, Los Angeles campus.

Members present: Regents Atkinson, Blum, Davies, T. Davis, Hopkinson, Lansing, Lee, Moores, Parsky, Pattiz, and Saban; Advisory member Ligot-Gordon

In attendance: Regents Johnson, Kozberg, Lozano, Marcus, Montoya, Morrison, Preuss, and Seymour, Regents-designate Sainick and Terrazas, Faculty Representatives Binion and Viswanathan, Secretary Trivette, General Counsel Holst, Treasurer Russ, Provost King, Senior Vice Presidents Darling and Mullinix, Vice Presidents Broome and Gomes, Chancellors Berdahl, Bishop, Carnesale, Cicerone, Dynes, Greenwood, Tomlinson-Keasey, Vanderhoef, and Yang, Acting Chancellor Warren, and Recording Secretary Nietfeld

The meeting convened at 3:00 p.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 March 13, 2002 were approved.

2. **PORTFOLIO ANALYSES AND INVESTMENT TRANSACTIONS (QUARTERLY REPORT)**

   Treasurer Russ reported that performance during the first quarter of 2002 had been flat, with a negative return of 0.4 percent for both the University of California Retirement Plan (UCRP) and the General Endowment Pool (GEP). On a fiscal-year basis, the return was a negative 1.5 percent for the UCRP, which is 20 basis points below the performance of the benchmark, and a negative 1.8 percent for the GEP due to its higher exposure to private equity, venture capital, and leveraged buy-outs. The value of The Regents’ portfolio increased by $190 million during the quarter, mainly due to growth in the 403(b) funds, cash inflows, and interest income in the Short Term Investment Pool.

   (For speakers’ comments, see the minutes of the May 15, 2002 meeting of the Committee of the Whole.)

3. **FOUNDATION REPORT AND FEEDBACK**

   Treasurer Russ recalled that at the University’s request Wilshire Associates had conducted a survey of the campuses to understand how investment assets were being managed by the foundations. Following a discussion of the survey results by the Investment Advisory Committee at its February 12 meeting, Committee Chair Hopkinson and IAC Chair Parsky
wrote to the foundations concerning the results of the survey as well as the proposed new investment policy for the General Endowment Pool. To date, five foundations have responded. In general, the responses to the proposed changes to the asset allocation plan for the GEP were positive, with a preference for wider ranges around the policy targets for foundation portfolios. A full report on the campus responses will be made to the Committee in July.

Committee Chair Hopkinson observed that the Office of the Treasurer had been in the process of developing options to allow the campus foundations to take advantage of The Regents’ investment opportunities. Treasurer Russ added that many of the foundations invest solely with The Regents.

Regent Parsky noted that while one objective is to improve the working relationship between the foundations and the Office of the Treasurer by offering more flexible investment options, The Regents retains the fiduciary responsibility to ensure that the foundations’ investment policies are sound.

Treasurer Russ continued with his report, noting that the foundations had expressed an interest in sharing The Regents’ asset allocation risk, return, and correlation assumptions. They responded favorably to the proposal to increase investments in private equity, given the University’s long-term exposure in this area. Another proposal is to put into place a more timely reporting mechanism for the foundations, including a quarterly reporting cycle. The foundations welcome an annual meeting with the Office of the Treasurer.

In response to a question from Regent-designate Sainick regarding the Regents’ fiduciary responsibility for funds managed by the campus foundations, General Counsel Holst recalled that the foundations exist as separate corporate entities that act in the name of the University of California. They are chartered for the purpose of raising funds for each campus and are covered by a series of policy statements and guidelines issued by the President. It was his judgment that the Regents have a fiduciary obligation to oversee the use of the University’s name as well as these fundraising activities. President Atkinson added that all of the expenditures of the foundations are required to go through the University.

Regent Hopkinson commented on the improved relationship between the individual campus foundations and the Office of the Treasurer under the direction of Treasurer Russ.

Mr. Russ reported that at its May 10 meeting, the Investment Advisory Committee had considered the option of having the foundations use the University’s custodial bank, which would result in more timely reporting as well as cost savings for the foundations.

4. **EXPANSION OF INVESTMENT OPTIONS FOR CAMPUS FOUNDATIONS**
Treasurer Russ reported that discussions had been under way regarding ways to offer the foundations additional investment options, including the Russell 3000 tobacco-free index, the MSCI EAFE tobacco-free index, and the Lehman Aggregate bond index. The foundations would be offered these options at low cost, with monthly entry into and exit from the index products. In addition, the foundations would be offered a private market investment option each year through the creation of a vintage-year portfolio, beginning in January 2003.

Regent Parsky stressed that these investments would be made within the parameters of the asset allocation plan which the foundations will have submitted to the Treasurer.

5. REVISION TO GENERAL ENDOWMENT POOL TARGET BENCHMARK

The Treasurer recommended, with the concurrence of Wilshire Associates, that the General Endowment Pool Target Benchmark be revised as follows:

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<thead>
<tr>
<th>GEP Recommended Asset Allocation</th>
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<tbody>
<tr>
<td><strong>Recommended Target Allocation</strong></td>
</tr>
<tr>
<td>U.S. Equity</td>
</tr>
<tr>
<td>Non-U.S. Equity</td>
</tr>
<tr>
<td>Fixed Income</td>
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<tr>
<td>Absolute Return</td>
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<tr>
<td>Private Equity</td>
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</tbody>
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Mr. Steve Nesbitt of Wilshire Associates based his presentation on a document entitled UC GEP Asset Allocation, which had been distributed to the Regents in advance of the meeting. He recalled that in March 2000 The Regents had approved an initial asset allocation plan which was intended to cover both the University of California Retirement Plan and the General Endowment Pool. At that time, Wilshire was directed to develop a strategy for the GEP that would be separate from that of the retirement plan because the overall policy was viewed as being too conservative for the endowment pool. He noted that the Treasurer and Wilshire Associates are now recommending a revision to the asset allocation plan for the GEP which adds an asset class known as “absolute return.” This strategy will align the targeted return with the long-term nature of the fund and also move closer to peer-fund allocations. A key characteristic of the endowment pool is its funding of the University’s long-term spending policy, currently 4.45 percent of assets, which is expected to grow in

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1 Absolute Return encompasses a range of investment strategies that provide protection against market declines while offering returns close to common stocks.
0.05 percent increments to 4.75 percent of rolling 60-month market values. The endowment pool encompassed $4.6 billion in assets as of December 31, 2001. Mr. Nesbitt compared the asset class return assumptions made by Wilshire in 1999 and 2002, noting a difference of negative 0.50 percent for the expected return from fixed income and a 0.25 percent increase in estimated inflation. The new class of absolute return has an expectation of earning 8 percent. He recalled that the policy adopted in 2000 called for a 53 percent allocation to U.S. equity and a 35 percent allocation to fixed income. At that time, the expectation was an 8.51 percent return on investments. Accounting for inflation and spending, it was estimated that the corpus would grow at a real rate of 1.55 percent per year. With lower bond yields, the expected growth has declined to 1.11 percent. As a result, the Treasurer and Wilshire are recommending an overall increase in the equity allocation and a greater diversity among equity components. U.S. equity will be reduced to 45 percent, while non-U.S. equity will increase to 10 percent and absolute return will be introduced at 5 percent. Finally, the allocation to private equity will increase from 5 to 10 percent, while fixed income will be reduced from 35 percent to 30 percent. These strategies will increase the projected return on the endowment to 8.69 percent and result in a real growth rate of 1.47 percent. Mr. Nesbitt observed that the recommended strategies appear conservative in comparison with the University’s peer institutions, which have a higher level of diversification and a larger proportion of their funds invested in private equity.

Regent Parsky reported that the Investment Advisory Committee had reviewed the proposal in some detail and would recommend that the revision to the asset allocation plan be approved. It was his understanding that the increase in risk for the portfolio was due more to the increase in the allocation to private equity rather than the creation of the absolute return category. Mr. Nesbitt confirmed that Wilshire believes that the absolute return strategy will enhance diversification while lowering risk, acting as a counterbalance to the increased investment in private equity.

Regent Parsky continued that the Investment Advisory Committee had urged that the Regents not pay close attention to the University’s peer institutions, which tend to have very different investment profiles. The advisory committee was also concerned that, if the plan is adopted, it be implemented in an orderly fashion. Regent Hopkinson added that there was the understanding that, during the first year, the commitment to private equity would increase only to its present target of 5 percent.

In response to a question from Regent Blum regarding the allocation to private equity, Mr. Nesbitt explained that the asset allocation policy targets the investment in venture capital at 65 percent of the total and leveraged buy-outs at 35 percent. This heavy emphasis is due in part to the University’s long history of investing in venture capital. This emphasis is expected to continue. With respect to a comment by Regent Blum regarding non-U.S. equity, Mr. Nesbitt noted that large institutions tend to invest in this asset class in order to diversify their portfolios. It was the opinion of the Investment Advisory Committee that it was an appropriate time to increase the allocation to non-U.S. equity because of lower P/E
ratios abroad. Sixty percent of the funds would be invested in Europe and 40 percent in Asia.

Regent Lee requested a definition of the category “absolute return.” Mr. Nesbitt explained that this strategy allows a manager to take positions with individual stocks while eliminating some of the market risk. The GEP will invest only in firms that disclose their holdings, and there will be an emphasis on merger arbitrage, distressed securities, and market neutral strategies.

In response to a question from Regent Saban, Mr. Nesbitt explained that the University’s investment in non-U.S. equity is in the Morgan Stanley index. If The Regents were to invest independently, the result would be a heavy concentration in Japan. Regent Parsky noted that the asset allocation plan had not given the Treasurer the discretion to choose international stocks but rather had called for investment in an international index.

Treasurer Russ confirmed for Regent Blum that the investment in absolute return will be managed externally.

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

The Committee went into Closed Session at 3:50 p.m.

The meeting adjourned at 4:35 p.m.

Attest:

Secretary