The Regents of the University of California

COMMITTEE ON INVESTMENTS
September 18, 2002

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

Members present: Regents Atkinson, Blum, Davies, Lee, Ligot-Gordon, Montoya, Moores, Parsky, Pattiz, and Preuss

In attendance: Regents Hopkinson, Johnson, Kozberg, Marcus, Sainick, and Terrazas, Regents-designate Bodine, Murray, and Seigler, Faculty Representatives Binion and Pitts, Secretary Trivette, General Counsel Holst, Treasurer Russ, Provost King, Senior Vice Presidents Darling and Mullinix, Vice Presidents Broome and Hershman, Chancellors Bishop, Cicerone, Córdova, Dynes, Greenwood, Tomlinson-Keasey, Vanderhoef, and Yang, Vice Chancellor Blackman representing Chancellor Carnesale, and Recording Secretary Nietfeld

The meeting convened at 9:45 a.m. with Committee Chair Parsky presiding.

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

Upon motion duly made and seconded, the minutes of the meeting of May 15, 2002 were approved.

2. **PRIVATE EQUITY RECOMMENDATION**

The Treasurer recommended that the guidelines for private equity be amended as shown below.

UNIVERSITY OF CALIFORNIA REGENTS

Non-Marketable Alternative Assets
Program Guidelines[1]

The purpose for portfolio guidelines is to clearly define performance objectives and to control risk. Portfolio guidelines to control risk should be subject to ongoing review.

Performance Objectives:

The objective of the private equity portfolio is to earn a return that exceeds the Russell 3000 Index return by 3 percent per year.

[1]Based on the March 16, 2000 Investment Strategy Study

Portfolio Guidelines:

A. Permissible investments include partnerships that invest in venture capital, buyouts, and non-U.S. private equity.

B. Co-investment and direct investments are not permitted at this time.

C. Fund-of-funds investments are permitted.

D. The target allocation to U.S. buyouts is ~~35 percent~~ 50 percent of the private equity portfolio with a minimum allocation of ~~25 percent~~ 30 percent and maximum allocation of ~~50 percent~~ 70 percent. U.S. buyouts is narrowly defined as traditional finance-oriented buyouts and growth capital buyouts. Real estate and mezzanine debt funds are not included.

E. The target allocation to venture capital is ~~65 percent~~ 50 percent of the private equity portfolio with a minimum allocation of ~~45 percent~~ 30 percent and maximum allocation of 70 percent. Venture capital includes early, middle, and late stage private investments in new high growth businesses.

F. The target allocation to non-U.S. private equity is 0 percent of the private equity portfolio with a maximum allocation of 10 percent. Non-U.S. private equity includes private equity and venture capital partnerships operating in Europe, Asia, and Latin America.

G. No single partnership ~~investment~~ *commitment* can represent, *at the time of commitment*, more than 5 percent of the *current* private equity allocation *defined as the most recent quarter book value plus unfunded commitments plus approved target commitment for the current (one) year.*

H. Investment in multiple funds of the same general partner is permitted. However, the total commitment to partnerships with the same general partner, *at the time of commitment*, can not exceed 15 percent of the *approved three year* private equity allocation *defined as current book value plus unfunded commitments plus approved commitment level for the current year and two subsequent years.*

I. The commitment to any individual partnership ~~cannot~~ *is recommended not to* exceed 20 percent of the total capital raised by the partnership. *The maximum of 20 percent represents the ownership percentage of the partnership at each closing*.

J. The private equity portfolio should be diversified across time as well. *At the time the budget is set*, ~~No~~ no more than 30 percent of the approved private equity *asset target* allocation can be committed to partnerships in any one year.

It was recalled that a summary of the private equity plan for The Regents' portfolios had been presented to the Investment Advisory Committee at its meeting on August 6, 2002. A number of the recommended changes to the guidelines for investment in private equity were discussed by the advisory committee; these proposed changes are now being presented to The Regents for action.

Target Mix: The guidelines for private equity investments state that 65 percent of assets be allocated to venture capital and 35 percent of assets to buyout funds. Analyses performed by the Office of the Treasurer on the risk and return characteristics of these two sectors indicate that the current heavier weighting of venture capital provides more risk than is prudent. The Treasurer is therefore recommending that the target policy for venture funds and leveraged buyout funds be adjusted to a 50:50 weighting. The Treasurer also recommends that a strategy focused on tier-one, high-quality managers be maintained. While the Office will manage to the targets, the nature of the asset class makes it difficult to rebalance quickly. The recommended target allocations are as follows:

- A target allocation of 50 percent to buyouts with a minimum of 30 percent and a maximum of 70 percent.
- A target allocation of 50 percent for venture funds with a minimum of 30 percent and a maximum of 70 percent.

Recommended commitments to Private Equity: The asset allocation plan calls for a 5 percent allocation to private equity in the University of California Retirement Plan, a 10 percent allocation in the General Endowment Pool, and a 6 percent allocation in the equity portion of the 403(b) fund. This equates to an asset level of $2.27 billion, which is $992 million above The Regents assets of $908 million on June 30, 2002 and unfunded commitments of $374 million. In order to reach this target, annual commitments will need to be approximately $600 million per year for five years assuming no growth in Regents' assets. Commitments need to be 35 to 50 percent higher than target asset levels because funds generally draw down only 85 percent of capital commitments. Typically some capital is returned before all committed capital is drawn, and some of the committed capital goes to pay fees. Therefore, an annual commitment level of $480 million to $600 million is recommended.

Recommended Changes in Policy Guidelines:

After careful review, the Treasurer recommends that the following guidelines be changed as discussed below:

- Guideline 7: The recommended guideline for a commitment to an individual partnership is 5 percent of the most recent quarterly book value of the portfolio, plus the unfunded commitments plus the current year's private equity approved allocation at the time of commitment. Currently this results in a maximum commitment of $102 million to an individual partnership.

- Guideline 8: The target for a general partner at the time of commitment is recommended to be 15 percent of the most recent quarterly book value of the portfolio, plus unfunded commitments plus the next three years approved private equity commitment allocation (the current year plus the two following years). Currently this results in a maximum of $435 million to $489 million limit to a single general partner.

- Guideline 9: The commitment to any individual partnership is recommended not to exceed 20 percent of the total capital raised by the partnership. The maximum of 20 percent represents the ownership percentage of the partnership at each closing.

- Guideline 10: The private equity portfolio should be diversified across time as well. At the time the annual budget is set, no more than 30 percent of the total private equity asset target can be committed to partnerships in any one year. Currently this results in the maximum private equity allocation per year of approximately $680 million based on the current private equity asset target of $2.27 billion.

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

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

Committee Chair Parsky commented that the Office of the Treasurer had been engaged in an extensive review of the entire portfolio. The Treasurer has presented detailed analyses of topics such as risk assessment to the Investment Advisory Committee.

Treasurer Russ recalled that in May 2002 The Regents had approved the addition of Treasury Inflation Protected Securities (TIPS) as a separate inflation-hedging asset class in the University of California Retirement Plan (UCRP). TIPS are U.S. Treasury bonds whose principal is adjusted for changes in the Consumer Price Index. Interest is paid semi-annually on the inflation-adjusted principal. As of September 10, 2002, The Regents' holdings in TIPS were $2.9 billion. This represents the strategic allocation of 5 percent in the dedicated portfolio plus a tactical holding of 1.4 percent in the fixed income portfolio. The TIPS portfolio returned 6.13 percent as of September 10.

Treasurer Russ presented a chart which displayed UC consolidated assets total returns for the second quarter, fiscal year, and calendar year to date. He commented on the performance for the UCRP, which was down 9.2 percent for the fiscal year compared with negative 7.7 percent for the benchmark. Similar returns were experienced for the General Endowment Pool. Mr. Russ stressed that much of the negative performance occurred in the final quarter of the University's fiscal year, which ended June 30, 2002, a period when equity markets were down.

Regent Parsky reported that the Investment Advisory Committee had been interested in comparing the performance of the equity portfolio versus the fixed income portfolio over long periods of time in order to determine how they should be managed as well as to understand how much risk had been undertaken in order to achieve the reported returns.

Treasurer Russ presented investment performance for the UCRP for the fiscal year ending June 30, 2002. He commented that the positive performance of the fixed income portfolio had served to somewhat balance the poor performance of the U.S. equity portfolio. Private equity was relatively flat for the year in relation to the benchmark.

Regent Hopkinson pointed out that the key issue for the Committee to focus on was the fact that the U.S. equity portfolio had significantly underperformed both the benchmark and the index fund.

Regent Blum observed that the fixed income portfolio had substantially outperformed the equity portfolio during the past five years. He believed that this performance called into question the ability of the equity managers in the Treasurer's Office to compete with outside professionals.

Treasurer Russ presented results for the General Endowment Pool and the various 403(b) funds. He then drew the Committee's attention to a chart showing how UCRP internally managed equity had performed relative to the benchmark over the past ten years, noting that the returns had been negative since 1996. Regent Parsky commented that, prior to the adoption of the asset allocation plan, the benchmark had been the S&P 500. Mr. Nesbitt of Wilshire Associates added that, on an annualized basis, the loss has been 10 percentage points relative to the benchmark. This pattern was the same during the 1980s.

Mr. Russ summarized his remarks by noting that the overall performance for both the UCRP and the general endowment pool was slightly greater than that of the policy benchmark for the trailing ten years due to the balanced asset allocation approach. Actively managed internal bonds were a positive contributor to overall balanced fund performance, greatly exceeding the appropriate benchmark for the trailing ten years. The bond portfolios also exhibited a higher risk than the benchmark as measured by standard deviation. The actively managed internal U.S. equity portfolios underperformed their benchmark in the long and short term, subtracting from the overall relative performance in the UCRP, GEP, and 403(b) equity fund. The addition of an index fund had saved the University significant value relative to the benchmark. The 403(b) equity portfolio did not benefit from the positive fixed income returns because the portfolio is invested 100 percent in equities.

Regent Hopkinson recalled that the policy adopted by The Regents called for a 5 percent investment in TIPS and a 5 percent reduction in fixed income and asked for specific information on whether that 5 percent represents the cap for the entire portfolio. Mr. Nesbitt explained that the 5 percent allocation will be measured separately from the smaller allocation to TIPS within the bond portfolio. Regent Hopkinson believed that The Regents'

intention had been a total allocation of 5 percent. Regent Parsky asked Treasurer Russ to report to the Committee on this issue.

The meeting adjourned at 10:10 a.m.

Attest:

Secretary