The Regents of the University of California

COMMITTEE ON INVESTMENTS
INVESTMENT ADVISORY COMMITTEE
August 26, 2003

The Committee on Investments and the Investment Advisory Committee met jointly by teleconference on the above date at Covel Commons, Los Angeles campus, Los Angeles; 1130 K Street, Suite 340, Sacramento; 4000 West Lake Boulevard, Homewood; and 12680 High Bluff Drive, Suite 200, San Diego.

Members present: ***Representing the Committee on Investments:*** Regents Connerly, Kozberg, Montoya, Moores, Parsky, and Preuss; Advisory members Binion and Ornellas

Representing the Investment Advisory Committee: Regent Parsky, Senior Vice President Mullinix representing President Atkinson, Mr. John Hotchkis; Consultants Cambon and Keller

In attendance: Secretary Trivette, Deputy General Counsel Lundberg, Treasurer Russ, and Recording Secretary Nietfeld

The meeting convened at 1:35 p.m. with Committee on Investments and Investment Advisory Committee Chair Parsky presiding.

1. **READING OF NOTICE OF MEETING**

For the record, it was confirmed that notice was served in accordance with the Bylaws and Standing Orders for a Special Meeting of the Committee on Investments and the Investment Advisory Committee for the purpose of considering Item 603, ***External Manager Search Process and Personnel***, and for the purpose of adding two teleconference locations.

2. **APPROVAL OF MINUTES OF PREVIOUS MEETING**

Upon motion duly made and seconded, the minutes of the meeting of April 22, 2003 were approved, Regents Connerly, Kozberg, Montoya, Parsky, and Preuss voting "aye."[1]

3. **INVESTMENT PERFORMANCE SUMMARY (QUARTERLY REPORT) AND INVESTMENT RISK REPORTING: ANNUAL REPORT ON INVESTMENT RISK IN UC RETIREMENT PLAN**

Treasurer Russ reported performance results for the fourth fiscal quarter and the second calendar-year quarter, which ended on June 30, 2003. For the fiscal quarter, the returns were

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[1] Roll call vote required by State law for all meetings held by teleconference.

strongly positive for both the University of California Retirement Plan (UCRP) and the General Endowment Pool (GEP), at 11.37 percent and 11.18 percent respectively, both trailing their policy benchmarks by about 30 basis points. The UCRP returned 5.63 percent, versus 5.36 percent for the benchmark, for the fiscal year ending June 30, 2003. Data provided to State Street, The Regents' custodian bank, by the Trust Universe Comparator Services show that both the UCRP and the GEP are in the top quartile of the peer group universe, outperforming both CalPERS and CalSTRS. Treasurer Russ reported that the year-over-year increase for the period June 2002 to June 2003 was $949 million for the UCRP and $170 million for the GEP. Turning to The Regents' consolidated assets, the Treasurer highlighted the fact that all funds had outperformed the benchmark for the fiscal year, with assets totaling $53,246,000,000. He presented more detailed results for The Regents' portfolios, noting in particular the addition of Absolute Return in the General Endowment Pool.

The Treasurer summarized his presentation for the quarter and the fiscal year by noting that the overall performance for both the UCRP and the GEP had been greater than the policy benchmark for the fiscal year and the five- and ten-year periods. Actively managed internal bonds were a major positive contributor to the overall balanced fund performance. The Treasury Inflation Protection Securities portfolio has added value over its benchmark since the inception of the program in July 2002. The actively managed internal U.S. equity portfolios underperformed their benchmark in the long and short term, subtracting from overall relative performance in the UCRP, the GEP, and the 403(b) equity fund. From an asset allocation perspective, performance in excess of the benchmark was accomplished by overweighting bonds in the first half of the year and underweighting bonds in the second half of the year.

Treasurer Russ noted that the **Annual Report on Investment Risk in UC Retirement Plan** had been mailed to all Committee members in advance of the meeting.

4. **PERFORMANCE BENCHMARK CALCULATION METHODOLOGY**

The Treasurer and The Regents' investment consultant, Wilshire Associates, recommended that The Regents approve the proposed calculation methodology for policy performance benchmark returns as described below:

A. For the University of California Retirement Plan (UCRP), the General Endowment Pool (GEP), and the 403(b) total fund policy benchmarks, a one-quarter lag will be incorporated retroactively for FY 2003 for the private equity benchmark, and this benchmark will be weighted using the actual weight of private equity in the respective fund.

B. For the UCRP and GEP total fund policy benchmarks, there will be a prospective FY 2004 incorporation of the real estate benchmark and weighting of this benchmark in a manner similar to that of private equity.

C. For the GEP total fund policy benchmark, there will be a prospective FY 2004 incorporation of the 5 percent policy weight to absolute return investments and the increase of non-U.S. equity from 7 percent to 10 percent. Correspondingly, the GEP total fund policy benchmark allocation to fixed income will decrease by 5 percent and the allocation to U.S. Equity will decrease by 3 percent.

Total Fund Policy Benchmark

Mr. Dennis Sugino of Wilshire Associates explained that the total fund policy benchmark is a quantitative management tool used to evaluate investment results. The benchmark measures success relative to the overall market and how the results were achieved. The benchmark identifies how much of the results were attributable to the asset allocation strategy, ongoing asset allocation management, investment manager performance, transaction, and other effects.

Benchmark Issues

Private equity and real estate investments are problematic in the calculation of the total fund policy benchmark because they are typically illiquid and not readily priced in the market. In addition, achieving target level allocations can be challenging because prudent investors must be opportunistic in committing assets. After much discussion, Wilshire and the Treasurer have developed a methodology that addresses the infrequent pricing and allocation lags with respect to these two asset classes in the total fund policy benchmark.

Lagging Returns

Incorporating same-period performance data from illiquid private equity and real estate investments can delay performance reporting by three months or more. Thus, as with the current UC performance, it is customary to have returns for these asset classes lagged by one quarter on a continuous basis. As an example, the investment performance for the calendar quarter ending June 2003 reports performance through June 2003 for all asset classes except private equity. For this asset class, performance for the period ending June 2003 actually is for the period ending March 2003. As such, the corresponding asset class benchmark also needs to be lagged. The private equity benchmark is the Russell 3000 plus 3 percent; therefore, Wilshire had recommended that the Russell 3000 Index be lagged one quarter to correspond to the measurement period of private equity. For future private real estate investments, the benchmark is the NCREIF Index, which already is lagged one quarter. This is common industry practice and will improve the performance measurement process. Public real estate, benchmarked to the Wilshire REIT Index, is marked to market and poses no similar measurement problems.

Asset Allocation Gap

The private equity asset class targets for the UCRP (5 percent), GEP (10 percent), and 403(b) (5 percent) and the 5 percent real estate allocations in the UCRP and GEP may not be fully achieved for several years due to market conditions and the availability of quality opportunities. Up to that point, there will be a gap between the actual amount invested in each asset class and the benchmark target weight. This gap may materially affect the total fund policy benchmark performance.

It is in the best interest of The Regents' funds that the Treasurer not be rewarded or penalized due to asset allocation gaps with respect to these two asset classes. Therefore, Wilshire has recommended that the total fund policy benchmark reflect the actual monthly investment weighting for these two asset classes until they achieve their target weights. For private equity, all uninvested assets shall be allocated to U.S. equities. For real estate, all uninvested assets shall be allocated 60 percent to U.S. equity and 40 percent to fixed income. This will neutralize the asset allocation gap issue in the total fund policy benchmarks until the asset classes are fully invested.

Timing of Changes

The Treasurer has proposed that the total fund policy benchmarks be retroactively changed for FY 2003 incorporating both the lagged private equity benchmark return and the actual private equity weight. Doing so will negatively affect the Treasurer's relative performance for FY 2003. For the UCRP, rather than outperforming the total fund policy benchmark by 1.06 percent, the Treasurer's Office would outperform by only 0.27 percent if this change were to be adopted. However, both the Treasurer and Wilshire believe these changes will create a fairer representation of the Treasurer's investment performance.

Additionally, on a prospective basis beginning with fiscal year 2004, Wilshire has recommended that real estate be incorporated into the UCRP and GEP total fund policy benchmarks in a manner consistent with private equity and that the GEP total fund policy benchmark incorporate absolute return investments up to the 5 percent policy weight.The non-U.S. equity allocation would increase from 7 percent to 10 percent. Correspondingly, the GEP total fund policy benchmark allocation to fixed income would decrease by 5 percent and the allocation to U.S. equity would decrease by 3 percent.

Upon motion duly made and seconded, the Committee approved the recommendation and voted to present it to the Board, Regents Connerly, Kozberg, Montoya, Moores, Parsky, and Preuss voting "aye."[2]

5. EXTERNAL MANAGER SEARCH PROCESS AND PERSONNEL

Treasurer Russ introduced Mr. Robert Blagden, newly appointed as the Managing Director of Externally Managed Investments, and called upon him to present the report, a copy of which had been mailed to the Committees in advance of the meeting. He recalled that The Regents had approved a change in the investment strategy by the adoption of an externally managed policy for investments in U.S. equity. The first step in the implementation of the program was the transfer of the internally managed equity portfolio to the Russell 3000 Tobacco-free Index Fund.

Mr. Blagden recalled that, under the proposal for external management, 75 percent of the domestic equity portfolio will remain in the Russell 3000 index fund, with an initial target of 25 percent of the portfolio to be managed externally by firms who manage only tobacco-free funds. The capitalization sizes will be kept fairly consistent with the overall market. The Treasurer's Office will issue two Requests for Proposals, one aimed at small-cap domestic equities and the other at large caps. Mr. Blagden noted that the Russell 2000, which accounts for approximately 8 percent of the market, consists of small-cap securities, while the Russell 1000 consists of the 1,000 largest capitalizations.

Turning to international equities, Mr. Blagden explained that the intention would be to put 50 percent in active strategies structured to maximize potential out-performance at acceptable levels of risk. The roles played by existing emerging markets managers will be reviewed prior to the issuance of the RFP.

In response to a question by Mr. Hotchkis regarding the difference in the percentage allocations for domestic and non-U.S. equities, Treasurer Russ explained that with respect to domestic equities, the initial intention would be to ensure that the external managers are adding value. If this is the case, he would return with a recommendation that the allocation be increased. The non-U.S. equities represent a much smaller portion of the portfolio; it is a more inefficient market where managers can add substantial value.

In response to a question from Regent Preuss, Mr. Blagden commented that for the UCRP, 56 percent of the assets are invested in domestic equities, with 55 percent for the GEP. The comparable percentage for international equities is 7 percent for both the UCRP and the GEP.

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Mr. Blagden continued that the first RFP would be issued in the third quarter of 2003. The number of managers to be selected is from five to eight, and the estimated allocation is $1 billion. An announcement of the manager selection will be made once they have been hired, at the latest in the second quarter of 2004. The large-cap RFP will be issued in the first quarter of 2004, and there will be an allocation of $5.2 billion to eight to twelve managers. The process will then shift to international equities, with a $1.6 billion allocation to six to nine managers.

Mr. Blagden outlined the external manager selection process. He explained that all firms that meet the minimum requirements may respond to the RFP, which will be available on the University's website. The Treasurer will be responsible for the selection process, with Wilshire Associates playing the role of affirming his decisions to The Regents. Both quantitative and qualitative assessments will be used in the selection process. There will be manager evaluations that are built from the bottom up; these evaluations will be complemented by top-down risk assessment in order to structure the asset class to provide the proper diversification.

In response to a question by Regent Parsky about the role that Wilshire Associates would play in the manager selection process, Mr. Steve Nesbitt of Wilshire explained that staff in the Treasurer's Office would independently review the qualifications of the applicants and make recommendations. As with private equity, Wilshire will provide an advisory statement that it agrees with the recommendations.

Mr. Blagden reviewed the Request for Proposal process, noting that the first step would be to review the applications to ensure that the firms meet the minimum requirements. Such requirements include an established track record and sufficient assets under management. The data provided by the firms will be loaded using Wilshires' Compass system, and the returns and holdings data will be verified. The staff will then analyze these data and determine the finalist candidates. There will be a detailed, analytic review of the holdings of these firms and site visits. The finalist firms will then be selected and funded. Mr. Blagden stressed that, in evaluating the managers, weight will be given to the investment approach, the organization, and the investment personnel. These factors will be given more weight than past investment performance results. However, past investment returns will be analyzed for consistency and patterns of performance.

Turning to the organization chart for the Externally Managed Investment Group within the Treasurer's Office, Mr. Blagden noted that, in addition to his appointment, the Investment Manager for Absolute Return Strategies position had been filled, with two openings remaining at the investment manager level. An analyst and a research position are also unfilled. Mr. Blagden outlined the characteristics that will be sought in the staff, noting that generalists with multi-asset class experience would be desirable. The individuals should function well in a team environment and should have experience analyzing potential investment firms and products using sophisticated investment software.

In concluding his remarks, Mr. Blagden indicated that the Treasurer would provide the Committees with regular updates on the process for retaining external managers, and manager performance will then be provided on a quarterly basis. The success of the program should be measured over a full business cycle of three to five years.

In response to a question by Regent Parsky regarding the timeline for implementation of the program, Treasurer Russ observed that the intention would be to move slowly due to the size of The Regents' portfolios. The managers who are selected will be expected to outperform the benchmark. If they do, more funds will be transferred to the successful managers, while investments with poor performers would be winnowed. Regent Parsky pointed out that the success of the portfolios overall will depend upon the amount of money that is allocated to the external managers. Treasurer Russ confirmed for Dr. Cambon that the intention would be over time to move to a 50 percent allocation to external managers.

Regent Parsky inquired about how the workload would be assigned to the investment managers within the Treasurer's Office. Mr. Blagden anticipated that they would be asked to oversee no more than twenty managers. He confirmed for Regent Parsky that the number of staff would be appropriate. Mr. Sugino continued that it would be the intention of Wilshire Associates to continue to submit quarterly reports on performance and to work closely with the Treasurer's staff. Regent Parsky recalled that the overall objective for implementing the external management process had been an ability to recruit sufficient internal staff to drive the process. The Regents will continue to have the advice and confirmation of Wilshire.

Mr. Nesbitt stressed that while Wilshire will work closely with the Treasurer on the successful implementation of the program, the firm works for The Regents.

The Committees went into Closed Session at 2:35 p.m.

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The meeting adjourned at 3:50 p.m.

Attest:

Secretary