The Regents of the University of California

COMMITTEE ON INVESTMENTS
INVESTMENT ADVISORY COMMITTEE
January 7, 2003

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

Members present: ***Representing the Committee on Investments***: Regents Davies, Lee, Ligot-Gordon, Montoya, Parsky, Preuss, and Saban; Advisory member Binion

Representing the Investment Advisory Committee: Regents Hopkinson and Parsky, Senior Vice President Mullinix representing President Atkinson; Consultants Cambon, Keller, and Lehmann

In attendance: Associate Secretary Shaw, General Counsel Holst, Treasurer Russ, Associate Treasurer Stanton, and Recording Secretary Nietfeld

Representing the Campus Foundations: Mr. Bob Beim, the UC Berkeley Foundation; Mr. Michael Child, the UC Davis Foundation; Mr. Herb Kawahara, the UCLA Foundation; Mr. Richard Otter, the UC Merced Foundation; Mr. Drew Zager, the UC Riverside Foundation; Mr. William Thomas, Jr., the UC Santa Barbara Foundation; and Mr. Arthur French, the UC Santa Cruz Foundation.

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

1. **INVESTMENT PERFORMANCE AND TRANSACTIONS ANALYSIS**

Treasurer Russ noted that while it was too early in the quarter to present performance data, he could report that the University of California Retirement Plan was up 5.2 percent for the quarter. He drew attention to a detailed report on long-term performance calculations for the UCRP, a copy of which had been mailed in advance of the meeting, which was intended to provide an explanation of the methods used to calculate long-term performance and to make comparisons with established benchmarks.

2. **UC CAMPUS FOUNDATIONS INVESTMENT GUIDELINES AND ANNUAL ENDOWMENT REPORT**

Regent Parsky recalled that the Treasurer had been working closely with Wilshire Associates to review the asset allocation guidelines that are used by the campus foundations. One objective of this review was to ensure that the foundations have the flexibility they require to achieve their performance objectives while employing an approach consistent with the fiduciary responsibilities of The Regents.

Mr. Steve Nesbitt of Wilshire Associates recalled that when the Treasurer had presented the endowment report two years ago, the Regents were informed that approximately $1.2 billion in assets were managed by the campus foundations. At that time, General Counsel Holst advised the Regents of their fiduciary responsibility for these foundation-managed assets. Following this discussion, Wilshire was asked to formulate recommendations pertaining to these funds. Mr. Nesbitt referred to a letter from Treasurer Russ to the foundation investment committee chairs which described two changes being proposed by Wilshire. The first would ask the foundations to consider adopting authorized target ranges for the asset allocation of foundation investment portfolios. The target ranges would be broader than those approved by The Regents for the General Endowment Pool (GEP).

UC Foundation Recommended Target Allocation

	Allowable Target	
	Minimum	**Maximum**
U.S. Equity	35%	55%
Non-U.S. Equity	8	12
Fixed Income	20	40
Absolute Return	0	6
Private Equity	0	20
Cash	0	10

Mr. Nesbitt stressed that the goal of the asset allocation plan for the foundations would be to achieve a consistency with the policies of The Regents with respect to the GEP without having a negative effect on the investment processes used by the foundations.

Mr. Thomas asked how often the foundations would be expected to rebalance to the targets. Mr. Nesbitt explained that while there are fairly strict rebalancing rules for the GEP, Wilshire had not stipulated any for the foundations. Regent Parsky added that the policies in place for the GEP would be available and could be adopted by the foundations.

Mr. Kawahara noted that the UCLA Foundation had adopted an asset allocation policy based upon advice from its consultants and asked whether it would now be required to adopt the targets being recommended by Wilshire. Regent Parsky explained that the intention was to ask the foundations what their policies are. As noted by Treasurer Russ in his letter, as of June 2002 all of the foundations were in compliance with Wilshire's proposed ranges. If a foundation's asset allocations were to fall outside of the recommended ranges, it would be asked to explain to the Committee on Investments why this was so.

Regent Hopkinson emphasized that the intention of the proposal would be for the foundations to stay within the recommended ranges and to rebalance their portfolios as necessary.

In response to a question from Regent Ligot-Gordon, several representatives of the foundations mentioned that the choice of whether or not to invest with The Regents is a function of the performance of The Regents' portfolios and the services provided by the Office of the Treasurer.

Mr. Nesbitt continued that the second recommendation being made by Wilshire was that an independent third-party custodian act as the performance calculation agent for all of the foundations. Currently, the Office of the Treasurer assembles the performance information for the annual endowment report from data provided by the foundations. New Governmental Accounting Standards Board regulations require that the foundations' assets be included in the University's financial statement. Having a single custodian would simplify the reporting process. The foundations would be asked to change from their current bank to a vendor to be selected by The Regents.

Mr. Karahawara recalled that The Bank of New York had been selected as the custodial bank for the UCLA Foundation through a Request-for-Proposal process. Mr. Nesbitt confirmed that the foundations would be able to provide input with respect to the selection of the single custodian.

In response to a question from Regent Parsky, Mr. Nesbitt explained that the Office of the Treasurer uses State Street as its custodial bank, while at least one foundation uses Union Bank of California and two use The Bank of New York.

Mr. Keller noted that the investment community is interested in accountability as well as the ability to track its investments by using technology to its fullest. He believed that Wilshire's proposal would provide this type of service to the foundations.

Regent Parsky noted that one objective would be to improve administrative efficiency across the system. He suggested that Treasurer Russ might wish to review with the foundations what the choice of a single bank would entail.

Mr. Nesbitt believed that it would be possible to demonstrate to the foundations with separate custodian banks that the consolidation of assets would provide greater leverage and economy, thereby adding value to the individual campuses.

Treasurer Russ noted that an alternative for those foundations that had gone through a recent RFP process and chosen a new bank would be for the University to provide a single platform to calculate performance through the use of State Street, which is The Regents' performance calculation agent. Mr. Kawahara acknowledged that this would be an acceptable alternative.

[The **Annual Endowment Report** was mailed to all Committee members in advance of the meeting, and a copy is on file in the Office of the Secretary.]

3. INVESTMENT RISK MEASUREMENT AND REPORTING

Treasurer Russ recalled that at the August 2002 meeting of the Investment Advisory Committee, Mr. Jesse Phillips had introduced the topic of risk management in the Office of the Treasurer, and he called upon Mr. Phillips to provide a follow-up report.

Mr. Phillips based his presentation on the document **Investment Risk Measurement and Reporting**, copies of which had been mailed to the Committee members in advance of the meeting. He began his comments by noting that risk is defined as the chance of loss accepted by an investor in order to earn a return, while risk tolerance measures the loss an investor is willing to sustain in order to generate an acceptable return. Risk management attempts to balance risk and expected return. The risk manager's primary objective is to ensure that the activities of the Treasurer's Office do not expose the University to potential or unexpected losses beyond The Regents' risk tolerance levels. The process begins with the setting of objectives and defining policies and guidelines; it involves periodic measurement, monitoring, analysis, and stress testing. Mr. Phillips noted that the intention will be to recommend that a risk policy be adopted by The Regents. The policy would be based upon the understanding that while the assumption of risk is necessary, it should be taken intentionally and be awarded appropriately. Risk reporting should be an integral part of the fiduciary oversight process. Mr. Phillips suggested that the policy could be implemented by articulating risk tolerance and translating that tolerance into metrics for risk. The Treasurer's Office is responsible for allocating risk to various strategies and for measuring and reporting risk against targets and ranges. Risk management may be seen as a natural extension of the asset allocation process that lies at the core of modern institutional investment.

Turning to the issue of how risk is measured, Mr. Phillips explained that the investment process is divided by multiple decision levels, with different risk metrics at each level. He provided the following definitions:

- **Surplus risk** - the risk of insufficient assets to meet liabilities or spending targets
- **Total asset/systematic risk** - the risk of underperforming one's strategic investment policy
- **Active/Residual risk** - the risk of unacceptable deviation from a style or benchmark.

The most widely accepted measures of asset risk focus on the volatility of the returns, typically around a benchmark or a target return. Mr. Phillips pointed out that diversification in the portfolio reduces risk, but risks that are defined as "systematic" cannot be diversified. For example, a pension fund must be invested. The principal investment decisions are which market risks should be taken and how much market risk should be assumed.

Included in the presentation were a series of charts illustrating the ways in which risk is measured for the UCRP. Mr. Phillips noted that, from an actuarial standpoint, the intention is always to have the assets exceed the Plan's liabilities.

Regent Parsky recalled that when he joined the Board little correlation was drawn between the performance of The Regents' portfolios and the liabilities of the retirement system. He believed that Treasurer Russ' introduction of risk management was an important step in bringing the two together. The Regents will need to consider how much risk they are willing to take in order to maintain a positive ratio of assets to liabilities. Regent Hopkinson added that when the percentage of overfunding is high, The Regents can afford to assume more risk.

Mr. Phillips confirmed for Regent Parsky that the overall goal of the risk management program would be to develop a long-term plan to increase the portfolio's expected return.

Regent Parsky noted that it would be important for the risk management staff to provide to the Regents on a regular basis an analysis of whether the risk being taken in the portfolio is appropriate within the overall asset allocation policy. Treasurer Russ confirmed that this would be his intention. Professor Lehmann suggested that the Treasurer use tables showing budgeted and realized risks by asset category. Mr. Phillips stated his intention of providing the Regents with a standardized quarterly report. In response to a further comment by Regent Parsky, Mr. Phillips noted that he would be implementing policies and procedures to ensure that the investment risks that are taken are understood and are commensurate with the return expectations.

Regent Parsky observed that the Office of the Treasurer would be willing to share its risk management expertise with the campus foundations. In addition, it is important to convey to the public that the Regents are paying close attention to the amount of risk in the portfolio.

4. **MEMORANDUM OF UNDERSTANDING FOR UC FOUNDATION PRIVATE EQUITY VINTAGE YEAR PORTFOLIOS**

Treasurer Russ recalled that one of the investment options being offered to the foundations was the opportunity to participate in a private equity vintage year portfolio. A Memorandum of Understanding between the Office of the Treasurer and the campus foundations has been prepared in consultation with the Office of the General Counsel and an outside consultant. This investment opportunity will be available to the foundations through January 31, 2003 and annually thereafter. Mr. Russ noted that The Regents' assets are invested in top-performing venture capital funds which are not available to many investors.

[The Memorandum of Understanding was mailed to the Committee members in advance of the meeting, and a copy is on file in the Office of the Secretary.]

Regent Parsky added that The Regents had adopted a procedure by which the Office of the Treasurer invests in private capital in consultation with Cambridge Associates.

In response to a question from Mr. Thomas, Treasurer Russ stated that while no minimum investment amount had been set, he anticipated that $500,000 could be a reasonable minimum investment. Mr. Kawahara commended the Treasurer for making this investment opportunity available to the campus foundations.

In response to a question from Mr. Zager, Regent Parsky commented that, as the private equity program grows, the Treasurer may wish to recommend to The Regents a more diversified private equity strategy.

(At this point Regent Lee left the meeting.)

5. **INVESTMENT PERFORMANCE AND TRANSACTION ANALYSIS**

Treasurer Russ noted that it would be appropriate to consider a portion of this topic and of Item 602X, ***Recommendation for Portfolio Rebalancing Process,*** in open session. He introduced Mr. Ross McLellan of State Street Global Advisors and asked him to report on the transition of the equity portfolio to the Russell 3000 tobacco-free index fund. Regent Parsky explained that The Regents had approved the Treasurer's recommendation that the internally managed equity fund be managed externally.

Mr. McLellan reported that the market value of the portfolio at the beginning of the transition on November 18, 2002 was $15,154,089,085 and at the conclusion it was $15,772,823,641, representing a gain of 4.08 percent, or 10 basis points below the Russell 3000 ex tobacco benchmark. This underperformance essentially resulted from transition costs. During the same period, if the transition had not occurred, The Regents' portfolio would have gained only 3.57 percent. The actual transition portfolio thus outperformed the legacy portfolio by 52 basis points over the transition period. Mr. McLellan explained that the goal had been to retain as many of The Regents' assets as possible through in-kind transfers and internal and external crossing. This was accomplished, with only 4.5 percent of the execution taking place through open market trade. The total transition cost was 10 basis points, as compared with potential transition costs of 59 basis points which would have occurred had the trading taken place in the open market. Finally, Mr. McLellan provided an update on the trading activity that took place in the open market in December. Performance data show continued outperformance as compared with the legacy portfolio.

(At this point Regent Davies left the meeting.)

6. **APPROVAL OF ASSET ALLOCATION REBALANCING POLICY**

The Treasurer and Wilshire Associates jointly recommended that The Regents approve adoption of the revisions to the rebalancing policy as set forth in the Attachment.

Mr. Nesbitt explained that the proposed revisions incorporate changes made to the asset allocation targets and ranges for the UCRP and the GEP at the May 2002 meeting, including the addition of Treasury Inflation Protected Securities to the UCRP and the addition of Absolute Return strategies for the GEP. The revision permits the Treasurer to use Commodity Futures Trading Commission-approved, exchange-traded futures contracts to rebalance the portfolio as necessary. With the elimination of the internally managed equity function, the Treasurer, with the concurrence of Wilshire Associates, will use futures contracts for the limited function of rebalancing the portfolios when necessary to comply with the approved asset allocation ranges regarding U.S. equity and fixed income.

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

The committees went into Closed Session at 3:25 p.m.

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The meeting adjourned at 4:25 p.m.

Attest:

Associate Secretary