The Regents of the University of California

COMMITTEE ON INVESTMENTS
INVESTMENT ADVISORY COMMITTEE
March 4, 2003

The Committee on Investments and the Investment Advisory Committee met jointly by teleconference on the above date at Covel Commons, Los Angeles campus; UCSF-Laurel Heights, 3333 California Street, San Francisco; 777 California Avenue, Palo Alto; and the University Center, San Diego campus.

Members present: ***Representing the Committee on Investments***: Regents Blum, Lee, Ligot-Gordon, Montoya, Parsky, Pattiz, Preuss, and Saban

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

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

The meeting convened at 1:40 p.m. with Committee on Investments and Investment Advisory Committee Chair Parsky presiding.

1. **INVESTMENT PERFORMANCE SUMMARY**

Treasurer Russ reported that both the University of California Retirement Plan (UCRP) and the General Endowment Pool (GEP) had positive returns of 5.2 percent for the second fiscal quarter, as compared with the 6 percent return of the policy benchmark. The result was in part attributable to the asset allocation rebalancing process. The major contributor to negative performance is the private equity portfolio relative to its policy benchmark, the Russell 3000 tobacco-free index plus 3 percent. Positive contributors for the UCRP included U.S. equity and Treasury Inflation Protected Securities (TIPS). For the fiscal year to date, the UCRP produced a negative return of minus 3.72 percent and the GEP produced a negative return of minus 3.75 percent, versus the policy benchmark return of negative 3.95 percent for the period. Overall, The Regents' portfolios gained $2.6 billion for the quarter.

2. **REAL ESTATE INVESTMENT STRATEGIES**

Regent Parsky recalled that the asset allocation plan adopted by The Regents does not include any strategies for investments in real estate either on a direct basis or through funds. Staff within the Office of the Treasurer have raised this strategy for the Regents to consider.

Treasurer Russ introduced Mr. Gary DeWeese of the Treasurer's Office and invited him to present the discussion on real estate investment strategies. Mr. DeWeese's presentation was based upon a detailed analysis that had been provided to the members of the Committees in advance of the meeting.

(At this point Regents Blum and Marcus joined the meeting.)

Mr. DeWeese reported that surveys of peer institutions, which consist of pension funds, endowments, and foundations, had found that peers who invest in real estate typically target 5 to 9 percent of assets in real estate, either public or private. He explained that public real estate investments are in the form of Real Estate Investment Trusts (REITS), while private real estate refers to direct or indirect investments through limited liability investment vehicles. The University's 26 education peers who invest in real estate have an average of 4 percent invested in private real estate and 3.1 percent invested in public real estate. By contrast, The Regents has approximately .8 percent by virtue of the representation of REITS in the Russell 3000 index.

Mr. DeWeese observed that while it is difficult to estimate real estate's share of the investable universe, most investors seeking to hold a diversified market portfolio usually consider adding real estate to the portfolio. He continued that real estate had shown favorable historical returns compared to other asset classes and offered some comments on the performance of the two real estate indices, the National Association of Real Estate Investment Trusts (public) and the National Council of Real Estate Investment Fiduciaries (private). The data support the view that investing in a blend of public and private real estate will produce a total risk and return somewhere between that of a U.S. equity and a U.S. bond. Real estate exhibits low correlation with stock and bond indices, primarily as a result of conditions in the real estate market. Risk may be reduced when real estate is added to the portfolio.

Mr. DeWeese discussed a table which compared the average dividend yield during the period 1993-2003 for REITs, S&P utilities, the S&P 500, and ten-year Treasury bonds. Currently, cash return from REITs is approximately 7 percent as compared with less than 2 percent for the S&P 500, 4.5 percent for S&P utilities, and 4 percent for ten-year Treasuries. Such high yield is attractive because it helps pension funds to meet their payout obligations and helps endowment funds to meet current spending needs. Real estate is increasingly taking the place of utility stocks to meet these obligations.

Mr. DeWeese observed that real estate has the potential to be a good hedge against inflation as most leases have some combination of inflation-indexed rent increases, rent step-ups, or expense pass-throughs. Construction costs rise during inflationary periods, which increases the feasible rent at new developments. He noted that real estate might also serve as a deflation hedge because local construction labor costs are not tied to global labor markets, and building materials are not susceptible to technological changes that reduce cost. A major caveat, however, is the fact that these theories work only if supply and demand are near equilibrium.

Mr. DeWeese observed that real estate had undergone a number of structural changes over the past ten years that have made it a more stable investment than in the past, and he outlined those changes for the Committees. He noted that, because of certain conditions, some inherent risks remain. Turning to current market conditions, Mr. DeWeese explained that while rents are falling, real estate prices are stable or even rising because investors need current yield and low interest rates are producing acceptable cash-flow returns.

Mr. DeWeese discussed the role of public and private real estate investment strategies. He outlined the benefits of a public strategy as follows:

- Good liquidity and real-time pricing
- Benefits from public market oversight and transparency
- Low transaction costs
- Instant diversification
- Ease of buy and sell decisions
- A good alignment of investor and management interests.

The private strategy offers the following advantages:

- Better opportunity to take advantage of private market inefficiencies
- The opportunity to purchase assets that are not publicly available
- Stronger low or negative correlations with stocks and bonds
- A better alignment of interests, provided the sponsor has invested a significant portion of net worth in the partnership
- More control over specific assets and management decisions.

Private real estate investments may either be in the form of direct ownership of assets or indirect ownership through limited liability investment vehicles, which is preferred. There are three strategies for investment in private real estate: core, value-added, and opportunistic; Mr. DeWeese outlined the characteristics of each of the three, noting that risk grows with return.

Mr. DeWeese presented an analysis of the potential impact of adding real estate to The Regents' balanced portfolios. The analysis was based upon the following options:

- Real estate target ranges of 4 percent, 7 percent, and 10 percent of assets.
- With the asset class, there would be sub-allocations of either:

  (1) Fifty percent to REITs, 30 percent to core, and 20 percent opportunistic; or
  (2) Twenty percent to REITs, 40 percent to core, and 40 percent opportunistic.

Funding would come from either 50 percent U.S. stocks and 50 percent U.S. bonds or 100 percent from U.S. bonds.

The analysis concluded that portfolio returns would increase for all scenarios for both the UCRP and the GEP. The projected increase is greater when the higher target allocations are used. Portfolio risks decrease for all scenarios when funding is provided by both the U.S. stock and bond portfolios, while they increase when funded 100 percent by a reduction in the U.S. bond portfolio.

In response to a question from Regent Blum regarding the management of a real estate portfolio, Regent Parsky pointed out that the discussion of real estate as an asset class was in its preliminary stage. The staff does not contemplate any direct investments in this class but rather will consider investments in partnerships, as outlined by Mr. DeWeese. If this strategy is adopted, it will be managed under the same types of procedures and guidelines that were adopted with respect to investing in private equity, working with an outside consultant. These guidelines would address issues such as the amount of each investment and the range of fees that would be charged.

Regent Marcus urged thoughtful consideration of this asset class. He confirmed for Regent Parsky that investment with outside partners would be the correct way to pursue this strategy.

(At this point Regent Marcus left the meeting.)

Mr. Michael McCook, Senior Investment Officer with CalPERS, reported on the role of real estate at CalPERS based upon a detailed slide presentation, copies of which were distributed to the members of the Committees. He explained that the goals of real estate investment were to generate attractive risk-adjusted returns, to diversify the risk of the overall portfolio, and to provide a hedge against inflation. The CalPERS real estate portfolio structure consists of core, core plus, and non-core. Core real estate investment offers numerous benefits in a mixed-asset portfolio, being both stable and inflation adjusted. Some characteristics of this portfolio include diversification by property type and geography and the inclusion of office, retail, industrial, and apartment properties. There are no direct investments in hotels because hotels are viewed as operating businesses. Mr. McCook explained that CalPERS invests in real estate through various partners and he identified them for the Committees. Turning to the non-core portfolio, Mr. McCook explained that this specialized portfolio primarily targets higher returns through investment in non-traditional real estate such as urban and senior housing developments, timber, and vineyards.

Mr. McCook discussed how the real estate investment process could be implemented by The Regents. The Committee on Investments would approve a strategic direction and related policies, including asset allocation, investment strategies, program timing, level of third-party discretion, and a compensation structure. Once such policies have been adopted, the program would be carried out by the Senior Investment Officer - Real Estate, with reports on investments being made to the Committee. As an illustration, Mr. McCook displayed charts which identified all of the investments in real estate made by his office on behalf of CalPERS and an organizational chart showing the responsibilities of the staff.

Regent Lee stressed that a key issue for The Regents to consider would be the choice of the partners. Regent Parsky noted that the list of partners displayed by Mr. McCook was the result of twenty years of investment in real estate. The Regents will need to focus on the concept of investing in limited partnerships that invest in a variety of different assets within the asset class.

Mr. McCook displayed a chart of CalPERS' total fund allocation as of December 31, 2002, with total assets at $133.8 billion. He noted that the targeted investment in real estate is 9 percent, including public REITs. The Board has defined a policy range of 50 percent to 80 percent in core real estate and 20 percent to 50 percent in specialized real estate; the present ratio is 77 percent:33 percent. In concluding his presentation, Mr. McCook stressed that the key point for a successful investment strategy was communication between the Office of the Treasurer and the Regents.

Regent Parsky recalled that the CEO of CalPERS had offered The Regents the opportunity to open discussions about using some of the procedures that had been developed by CalPERS. Regent Blum observed that Mr. McCook had demonstrated that CalPERS has adequate staff to invest wisely in this asset class in house. He did not believe that the Office of the Treasurer would have this capability and suggested that the University would either have to work with outside consultants or come to some sort of an agreement with CalPERS.

3. **REVIEW OF PRIVATE EQUITY PERFORMANCE BENCHMARKS**

Treasurer Russ recalled that The Regents' benchmark for investments in private equity is the Russell 3000 + 3 percent. The Treasurer's Office has always reported lagged private equity returns; this reporting methodology creates anomalous results for the quarter being reported. Several methods for comparing private equity performance to the benchmark and to alternative benchmarks were examined. The results indicate that the actual private equity performance returns compared to lagged benchmarks provide the most relevant, timely, and robust comparisons. For example, private equity returns reported in December should be compared with benchmark returns for September, the actual time period in which they were generated. Treasurer Russ presented some detailed charts outlining how the proposal would work, copies of which had been mailed to the Committees in advance of the meeting. Regent Saban expressed concern about valuation on non-liquified assets. Ms. Urban of Cambridge Associates noted that cash invested and distributed, net of fees, makes the difference for this asset class. There is an inherent disconnect in terms of timing and valuation methodology when looking at investment results over short periods of time. One issue relates to investments that were made during the bubble period of 1998-2000, with significant declines in value to date. There is a methodology in private equity whereby the assets are typically held at cost until there is third-party financing. At that time, the assets are written up to that level. Returns are based upon the audited financial statements of the venture capital partners.

(At this point Regent Lee left the meeting.)

Regent Parsky observed that The Regents had allocated a 5 percent to 10 percent range for investment in private equity. The objective over time is to achieve better results than the Russell 3000. Investors who choose this asset class must recognize that it is a lengthy investment process and must be willing to assume some level of risk in the interim. Currently the University, as a limited partner, takes the valuations that are being carried by the partnerships for unrealized investments and builds them into the performance reports. Some partners do an evaluation only once per year. He recalled that the level of investment in private equity by The Regents during the bubble period had been much lower than 5 percent. Because of the University's reputation and position, it was able to participate in venture capital partnerships in earlier periods when significant gains were achieved. An important issue will be how to measure the effect of the performance in private equity on the performance of the overall portfolio.

4. **PERSONNEL ISSUES: EXTERNAL MANAGEMENT GROUP**

The Report on the Recruitment Plan for Staffing the Externally Managed Investment Group was submitted for information.

> [The report was mailed to the Committees in advance of the meeting, and a copy is on file in the Office of the Secretary.]

The Committees went into Closed Session at 3:40 p.m.

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The meeting adjourned at 4:00 p.m.

Attest:

Associate Secretary