The Regents of the University of California

COMMITTEE ON INVESTMENTS
INVESTMENT ADVISORY COMMITTEE
November 9, 2004

The Committee on Investments and the Investment Advisory Committee met jointly by teleconference on the above date at the following locations: James E. West Alumni Center, Los Angeles campus; UCSF-Laurel Heights, 3333 California Street, San Francisco; and 2223 Avenida de la Playa, La Jolla.

Members present: ***Representing the Committee on Investments***: Regents Anderson, Lee, Montoya, Ornellas, Parsky, Preuss, and Wachter; Advisory member Blumenthal

Representing the Investment Advisory Committee: Regent Lee, Senior Vice President Mullinix representing President Dynes, Mr. David Fisher, Mr. William Hambrecht, Mr. John Hotchkis, Mr. Charles Martin; Consultants Cambon, Child, and Lehmann

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

The meeting convened at 1:40 p.m. with Committee Chair Lee 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 addressing items on the Committees' agenda.

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

Upon motion duly made and seconded, the minutes of the meeting of August 17, 2004 were approved, Regents Anderson, Lee, Montoya, Ornellas, Parsky, Preuss, and Wachter (7) voting "aye."[1]

3. **QUARTERLY AND FISCAL YEAR INVESTMENT PERFORMANCE SUMMARY AND RISK REPORT**

Treasurer Russ presented performance results for consolidated assets for the third fiscal quarter, the fiscal year-to date, and the calendar year-to-date, noting that the University of California Retirement Plan (UCRP) had returned 0.51 percent in the quarter versus the

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

policy benchmark's return of 0.69 percent, while the General Endowment Pool saw a return of 0.37 percent against the policy benchmark. The total assets for the quarter are $59.24 billion. Mr. Russ noted that the fixed income portfolio of the UCRP had a positive return of 4.75 percent, while Treasury Inflation Protection Securities (TIPS) produced a 3.87 percent return. The private equity portfolio continues to contribute to underperformance. Treasurer Russ discussed the table which outlined portfolio market value changes for the quarter for all investment classes. Three hundred eighteen million dollars were paid out in benefits, while the UCRP gained $194 million due to investment activities, resulting in a net change of minus $124 million. For the one-year period, the retirement plan had a net change of plus $2.3 billion.

In response to a comment by Regent Parsky, Treasurer Russ recalled that, as reported at the August meeting, the search for small-cap equity managers had been completed, and proposals from the large-cap managers were under review. The Treasurer's Office selected a set of managers and a portfolio was put into place on September 30. The Office is in the process of interviewing international managers, with a goal to have 25 percent of non-U.S. equities actively managed.

4. **TREASURER'S ANNUAL REPORT, 2003-04**

The Treasurer recommended that the Committee on Investments forward to The Regents The Treasurer's Annual Report for the fiscal year ended June 30, 2004.

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

It was recalled that the Bylaws state that the Committee on Investments will report periodically to the Board concerning the investment operations of the University. The Treasurer's Annual Report goes into detail concerning these operations.

Upon motion duly made and seconded, the Committee approved the Treasurer's recommendation, Regents Anderson, Lee, Montoya, Ornellas, Parsky, Preuss, and Wachter (7) voting "aye."[1]

5. **REAL ESTATE INVESTMENT PROGRAM UPDATE**

Treasurer Russ indicated that Item 603, ***Proposed Investment Policy Statement (IPS) for the UCRP***, contains recommendations pertaining to real estate and that, as a result, he had determined that the background information contained in the ***Real Estate Investment Program Update*** should be presented first in order to inform the Committee's understanding of the proposals presented in Item 603.

Treasurer Russ introduced Mr. Jon Willis, the manager of the real estate investment program, who was recruited to the Office of the Treasurer following a nationwide search. Mr. Willis assisted the Office in the retention of The Townsend Group as its real estate consultant. Mr. Russ recalled that at its meeting on April 22, 2003, the Committee voted to recommend to The Regents a new five percent allocation of the University's retirement and endowment plans to real estate. Changing market conditions since that time have resulted in an amended investment program, which he called upon Mr. Willis to present.

Mr. Willis explained that, as five percent of the portfolios, the allocation to real estate would be in the range of $2.5 billion to $3 billion when it is fully deployed over the next five to six years. This investment would rank the University's program among the top 15 in the country in terms of size. He underscored the fact that investments would be made only in private real estate funds or, in the case of real estate securities, only with third-party managers. The program will have no directly held assets. Mr. Willis recalled that the original intentions with respect to the real estate investment program were to diversify the portfolio and to take advantage of the excellent performance of this asset class.

Mr. Willis introduced Ms. Micolyn Yalonis of The Townsend Group and asked her to describe the conditions that currently prevail in the real estate market. Ms. Yalonis explained that there are three aspects of market conditions that serve as the main factors in the evaluation of an investment in real estate: improving property fundamentals, increasing capital flows into the asset class, and capitalization rate compression. The fundamentals of the institutional property market, defined as occupancy levels, rental rates, and other indicators of the general health of the sector, steadily weakened between late 2000 and 2004. Despite this weakening, real estate prices generally held steady or even improved because of the continuing demand for this asset class. The economy has begun to recover, and the fundamentals of real estate are beginning to show that recovery. The increase in capital flows provides a challenge because the University is not a unique institutional investor. In 2003 the total real estate capital in the country was $190 billion; this figure is projected to grow to $260 billion in 2004. The consensus is that investment in real estate will continue to return between seven and eight percent annually. If interest rates increase and capital flows to other areas, the price of investing in real estate would increase. Ms. Yalonis predicted that such capitalization rate expansion would occur in the future, as it happens in every cycle. She also anticipated that fundamentals would improve at the same time. Townsend has been working with the Treasurer to identify alternative strategies while creating the core exposure.

Mr. Willis outlined the investment strategies that would be used in the development of the real estate program:

Strategy	Program	Access	Policy Allocation	Range
Core	Private	Open-ended funds	50%	30%-60%
REITs[2]	Public	REIT managers	10%	5%-20%
Enhanced	Private	Closed-end funds	25%	20%-35%
High Return	Private	Closed-end funds	15%	0%-25%

Mr. Willis noted that this proposal represents a significant change from the approach originally adopted by The Regents, which contemplated a dual public-private investment strategy. The primary reason for this change is that public real estate investments are closely correlated with equity investments. The core strategies will be implemented through investments in eight to ten funds; the universe of both existing and new open-end fund managers will be actively reviewed to ensure that the University's program is invested with the best-performing and best-managed funds. These are semi-liquid investments, with investors having the ability to add to or subtract from their interest in these pools, generally on a quarterly basis.

The non-core strategies – enhanced and high return – are typically six to eight years in fixed duration. The Treasurer's staff will select fund managers who have demonstrated their ability to implement the proposed strategies.

Mr. Willis discussed the core, enhanced, and high-return investment strategies in terms of risk and return, with the core strategies providing both the lowest return and risk. Core strategies are investments in high-quality, well-located properties that are operationally stabilized. The income provided by these investments is generally durable from year to year. Enhanced strategies usually entail the turn-around of a property that has been under-managed or under-maintained. The risk and return are moderate. The high-risk, high-return strategy often requires distressed sellers or assets. An exception is new development, which has its own set of risks. Mr. Willis presented slides illustrating the expected impact of the real estate program on the overall performance of the University's investments.

Mr. Willis also presented the three-year implementation model for committing the real estate allocation. The actual deployment will depend upon market conditions and the availability of investment products. The goal will be to achieve the policy weightings at the conclusion of the three years. The plan illustrates the intention to invest in higher-return strategies where the property risk is less than the pricing risk in the core strategies.

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[2] Real Estate Investment Trust

Regent Parsky asked for comment on how investing in real estate would improve the performance of the overall portfolio. Mr. Willis explained that meeting the benchmark under the policy allocation would increase the overall return by ten basis points, and it would reduce the volatility in the portfolio by about fifty basis points.

The investment selection process will be similar to the one used in the selection of private equity. There are multiple opportunities to reject a proposed investment, and all investment selections must be approved by the Treasurer's Office and the outside consultant. Ms. Marie Berggren, managing director of alternative investments, noted that various criteria are used to evaluate a private equity investment. She confirmed for Regent Parsky that the consultant would provide a "prudent man" opinion for each commitment; the same will be true for the real estate asset class.

Investment Guidelines – Private Real Estate

- The benchmark for evaluating the performance of private real estate investments is the National Council of Real Estate Investment Fiduciaries' (NCREIF) Property Index. The program is expected to meet or exceed this benchmark after deducting all costs and expenses.

- Investments will be in limited liability vehicles such as limited partnerships, limited liability corporations, private REITs, and other pooled investment funds. There will be no direct investments.

- Investments will be primarily equity oriented but may include debt instruments secured by real estate.

- Specific property types in the portfolio will be within the following ranges:

Office	20 percent to 50 percent
Apartments	15 percent to 35 percent
Industrial	15 percent to 35 percent
Retail	10 percent to 30 percent
Other	up to 10 percent

- Investments in the U.S. will be diversified by geographic location with no single metropolitan area exceeding ten percent of the portfolio.

- Investments outside the U.S. may not represent more than ten percent of the private real estate portfolio and must be diversified by property type and geographic location.

- An investment in any one fund will not exceed 20 percent of the total capital being raised for that offering.

- No more than ten percent of the program's assets will be invested with a single core manager, and no more than five percent will be invested with a single non-core manager.

- The outstanding investments with any given sponsor may not exceed 15 percent of that manager's assets under management.

- The sponsor of a closed-end fund investment will be required to make a co-investment of at least one percent.

- Leverage at the portfolio level will not exceed 50 percent of the market value of the assets.

Mr. Willis commented that the program that was adopted in 2003 had permitted investments of up to 20 percent in non-U.S. real estate, as compared with the new guidelines, which limit this class to 10 percent. The staff in the Treasurer's Office does not believe it has the capability to find opportunities outside the country at this time; this strength will be developed in the future. Treasurer Russ added that the guidelines also permit investments in funds with minor international exposure. No commitments in this category have been made.

Investment Guidelines – Public Real Estate

- The benchmark for evaluating investment performance for REIT managers is the Dow Jones-Wilshire REIT Index.

- At least 90 percent of the portfolio assets must be invested in securities included in the benchmark index.

- No property type may exceed two times that property type's weight in the benchmark index.

- The weighting of any individual security cannot exceed more than two times its weight in the benchmark index.

- Investments in any given security may not exceed 4.5 percent of the equity capitalization of that security.

- No investment with any single manager may represent more than 25 percent of the public real estate portfolio.

- No investment with any single manager may exceed 25 percent of that manager's total assets under management.

Mr. Willis reported that the implementation of the real estate investment program had begun with two investments, PRISA II and AMB Institution Fund III. The commitment to PRISA II, a core-plus investment strategy, was $100 million. PRISA II is a $2 billion, open-end fund sponsored by Prudential Real Estate Investors. To date, $10 million has been called; the balance will be invested over the next two years. The fund has consistently outperformed its peers, primarily through investing in new properties. The second investment was a $30 million commitment to AMB Institutional Fund III, which is a new open-end fund investing primarily in specialized industrial properties.

Regent Parsky saw the need for continued review of the guideline which states that the Treasurer is permitted to invest up to 20 percent of the total capital being raised for an offering. The Treasurer tends to limit investments in private equity to ten percent.

Treasurer Russ noted that, for private equity, 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. Notwithstanding these limitations, commitments to any fund-of-funds partnership are recommended not to exceed 35 percent of the total capital raised by the partnership.

Mr. Willis explained that the prospective investments being considered are JPM Strategic Property Fund (core), RREEF America II (core), TA Associates VII (enhanced), and RREEF America III (enhanced). A commitment of $100 million each will be made to the two core funds, both of which are large, diversified property portfolios with excellent performance records. Because of existing entry queues, the investments will most likely occur in mid-2005. The two enhanced investments will prospectively include commitments of $50 million each. During the first half of 2005, the intention will be to identify high-return propositions, which will include a number of non-U.S. offerings with attractive risk-adjusted returns. These offerings are all sponsored by large, U.S.-based investment managers with established teams in the targeted markets. The initial review will focus on opportunities in Western Europe, Japan, and Mexico.

In response to a question from Mr. Fisher regarding the intention to use the highest-risk strategy to invest outside the United States, Mr. Willis commented that one perspective would suggest that U.S. strategies will not yield the types of returns that the non-U.S. strategies will. Mr. Cambon pointed out that during a different business cycle, distressed opportunities might present themselves in the United States. Mr. Willis emphasized that the intention will be to seek the highest returns. It is his belief that those higher returns will be outside the United States. It would be unwise to seek lower-return strategies in the non-U.S. market because the same returns can be obtained in this country.

Mr. Martin emphasized that an investment in real estate outside the United States was part of the Treasurer's diversification strategy. He believed that it would be valuable to create a specialized advisory committee that would serve as a resource for the Treasurer's Office as real estate investment decisions are made.

Regent Parsky suggested that another approach would be to add a member of the IAC who has detailed real estate experience, especially in light of the expectation that The Regents will commit $2.5 billion to this asset class. He urged the Treasurer to use caution when considering any non-U.S. investments. Committee Chair Lee also commented on the risks inherent in investing in foreign real estate.

Mr. Willis agreed to take the Committee members' comments seriously when evaluating any investment in non-U.S. real estate. Ms. Yalonis noted that at present there are no opportunities for investing in core international funds.

Following further discussion, Treasurer Russ stated the intention to research the topic of investing in non-U.S. real estate and to present a report to the Committees at the February 2005 meeting.

6. **PROPOSED INVESTMENT POLICY STATEMENT FOR THE UNIVERSITY OF CALIFORNIA RETIREMENT PLAN**

The Treasurer recommended that the attached Investment Policy Statement for the University of California Retirement Plan be approved.

Treasurer Russ recalled that in November 2003 The Treasurer's Office began a project to consolidate all the investment policies that The Regents has approved over the years into a single document: The Investment Policy Statement (IPS). The Office has also assembled an electronic database of all of The Regents' approvals with respect to the Office of the Treasurer and the investment function. Proposed changes to performance benchmarks will be effective for the quarter beginning January 1, 2005.

The Treasurer's Office had hoped to present the IPS to the Committee on Investments last spring. The change in the generalist investment consultant between March and July 2004 provided an opportunity to further refine the document.

The objective is to construct a document that will clearly articulate the responsibilities of The Regents, The Committee on Investments, and the Treasurer with respect to the development and implementation of the investment policies. The current document deals with the UC Retirement Plan only. Treasurer Russ stated his intention to follow up with investment policy statements for the General Endowment Pool and the other funds under his management on behalf of The Regents and beneficiaries.

Mr. Tom Richards of Richards & Tierney, The Regents' investment consultant, recalled that one of the first questions he had asked after being retained was about the existence of an investment policy statement. Richards & Tierney believes that a well-thought-out policy statement is the foundation upon which all successful investment programs are built. An IPS addresses governance and should include best practices. The document lists not only a fund's investment policies but also its mission, philosophy, objectives, risk tolerance, procedures, strategies, and decision makers. It identifies all of the fund's investment risks and specifies risk-budgeting methods and risk-management procedures to ensure that the outcomes are consistent with expectations. An investment policy statement addresses issues of responsibility, authority, and accountability, which leads to evaluation and assessment. The IPS is a dynamic document that is always open for review and revision. Richards & Tierney found that there existed a variety of investment policies for the University which had not been consolidated into a single coherent framework. The firm believes that such a policy statement is critical to the success of the investment program. Richards & Tierney has been actively involved in the preparation of the proposed Investment Policy Statement and recommends that it be adopted for the UCRP.

Treasurer Russ recalled that there had been substantial changes in The Regents' philosophy toward governance, investment strategy, and managing risk since 2000, with closer oversight on the part of the Committee, the IAC, and the Office of the President. There is increased complexity in the investment strategies as well as increased benchmark sensitivity. The IPS defines performance objectives and outlines fiduciary oversight procedures. Investment guidelines are provided for each asset class, and there are general guidelines for all investment managers. The IPS has a focus on the management of risk because without risk, there are no returns. The Committee assesses the risk tolerance and sets an overall risk budget through the asset allocation process. The Committee also approves the budget and ranges for various risk measures and approves the benchmarks. The Treasurer implements asset allocations within those risk limits.

The elements of the investment program that have not changed include the reporting by the Treasurer to the Committee on quarterly investment results and risks. There has been no change to the overall equity-bond allocation of 65 percent-35 percent, and there is no change to the benchmarks except for private equity. The essence of investment governance is to balance flexibility in the use of professional judgment to implement the policy with the requirement to manage and control risk.

Mr. Russ summarized the major changes contained in the proposed Investment Policy Statement as follows:

- Various investment risks are identified, and responsibility and accountability are clearly defined.

- The Committee sets the risk budget and the ranges for total and active risk.

- There is recognition of interim allocations for the purpose of setting ranges around the policy weights due to the illiquid nature of private equity and real estate.

- The IPS combines public equity classes for the purpose of setting ranges around the policy weights, which increases the combined range of plus or minus seven percent to plus or minus ten percent.

- Specific percentages of active versus passive management within asset classes have been replaced by total fund and asset class risk budgets.

- The total fund benchmark is modified by using actual private equity return as the benchmark in order to neutralize the impact of private equity on active return.

- There is the addition of a derivatives policy and the use of risk budgeting.

In response to a comment by Mr. Fisher that the policy does not address the risk of losing money, Mr. Richards noted that when the asset allocation decision is set there are expectations formulated with respect to returns over a risk-free rate. There is a range of uncertainty which recognizes the possibility that the fund could produce negative returns for a period of time. Mr. Fisher believed that this statement should be explicitly recognized within the policy. Professor Lehmann pointed out that the performance summaries report the returns versus the benchmark, which provides a clear way of identifying the sources of return.

Ms. Ann Posey of Richards & Tierney explained that under the proposed policy, for private equity long-term portfolio returns will be compared to investable public equity alternatives as well as non-investable peer group indices. There is no appropriate benchmark to use for short-term performance evaluation or decision making. The actual returns on the private equity investments will be shown for the quarter and the year. Regent Parsky asked how the Regents would be able to assess the performance of that segment of the portfolio. Treasurer Russ noted that since 2002 he had been reporting the performance versus investable benchmarks as they are more appropriate for private equity.

Mr. Martin pointed out that while longer-term measures provide a good perspective on performance for private equity, there should be a way to perform evaluations within a shorter time frame. Mr. Richards noted the intent to perform a specialized analysis. Treasurer Russ added that the trend for endowments has been to take private equity out of the equation for the publicly traded markets because the returns do not represent the actual behavior of the portfolio.

Regent Parsky pointed out that it was the expectation of The Regents that investment in private equity would improve the overall performance of the portfolio. As a result, its performance needs to be incrementally higher than other segments, such as public equity and fixed income.

Mr. Martin suggested that it would be valuable for the Committees to meet annually with the private equity group for a review of performance. Regent Parsky saw the need for a regular reevaluation of the allocations to the various asset classes. The Regents should be informed as to how private equity is contributing to the overall portfolio.

Ms. Berggren observed that the results of investing in a venture capital fund are not known until ten to twelve years after the investment is made.

Committee Chair Lee asked that there be a special meeting of the Committees to discuss the issue of investments in private equity and asked the Treasurer to schedule such a meeting. He supported evaluating performance on a long-term basis.

Regent Parsky noted that while the Committees had concurred with the proposal to remove the benchmark for private equity, the Treasurer should continue to report to The Regents on the long-term contributions to the portfolio being made by the private equity asset class. Treasurer Russ confirmed that he would continue to present results compared with various benchmarks.

Senior Vice President Mullinix added that there should be a review of the performance over the past three to five years. Mr. Richards offered the assistance of Richards & Tierney to the Treasurer's Office with respect to the evaluation of the performance of the private equity portfolio.

Upon motion duly made and seconded, the Committee approved the Treasurer's recommendation and voted to present it to the Board, Regents Anderson, Lee, Montoya, Ornellas, Parsky, Preuss, and Wachter (7) voting "aye."[1]

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

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The Committees went into Closed Session–Regents Only at 3:33 p.m.

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The meeting adjourned at 3:40 p.m.

Attest:

Associate Secretary