The Regents of the University of California

COMMITTEE ON INVESTMENTS
INVESTMENT ADVISORY COMMITTEE
February 15, 2005

The Committee on Investments and the Investment Advisory Committee met jointly by teleconference on the above date at the following locations: UCSF-Laurel Heights, 3333 California Street, San Francisco; James E. West Alumni Center, Los Angeles campus; and 1130 K Street, Sacramento.

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

Representing the Investment Advisory Committee: Regents Lee and Pattiz, Senior Vice President Mullinix representing President Dynes, Mr. David Fisher, Mr. Charles Martin; Consultants Beim, Cambon, Child, and Lehmann

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

Representing the campus foundations: Mr. Rick Keller, the UC Irvine Foundation; Mr. Lee Kolligian, the UC Merced Foundation; Mr. Bill McKay, the UC Santa Cruz Foundation; and Mr. Peter Taylor, the UCLA Foundation.

The meeting convened at 1:40 p.m. with Committee on Investments and Investment Advisory 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. **PUBLIC COMMENT**

Committee Chair Lee explained that the public comment period permitted members of the public an opportunity to address University-related matters. The following persons addressed the Committees.

Ms. Jeannie Biniek, Ms. Tina Park, and Mr. Lawrence Farry, students at the Los Angeles campus, called upon The Regents to adopt a return-to-aid policy that would restore financial aid funding to one-third of student fees rather than the 25 percent called for under the compact with the Governor.

3. **APPROVAL OF MINUTES OF PREVIOUS MEETING**

Upon motion duly made and seconded, the minutes of the meeting of November 9, 2004, were approved, Regents Anderson, Lee, Montoya, Ornellas, Parsky, Preuss, and Wachter (7) voting "aye."[1]

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

Treasurer Russ presented performance results for consolidated assets for the most recent quarter, the fiscal year-to-date, and the calendar year-to-date, as well as annualized total returns over three, five, and ten years. He noted that the University of California Retirement Plan (UCRP) had returned 8.05 percent in the quarter versus the policy benchmark's return of 7.25 percent, while the General Endowment Pool saw a return of 8.42 percent against the policy benchmark of 7.28 percent. The High Income Pool provides income to several campuses for scholarships; although it underperformed the benchmark, it has a high return for an interest-bearing account. The Short Term Investment Pool grew by 3.42 percent in the calendar year. The total assets for the quarter are $62.97 billion. Mr. Russ discussed the investment performance of the UCRP based on asset class, noting that decisions made with respect to asset allocation had contributed to the overall positive results. Turning to private equity, the Treasurer presented data reported as of December 2004 corresponding to benchmarks effective September 2004. He drew the Committees' attention to the major contribution made by venture capital, with a 78.58 percent return in the calendar year for the retirement plan, 112.23 percent for the GEP, and 250.02 percent for the 403(b) equity fund.

In response to a question from Consultant Beim, Treasurer Russ confirmed that an analysis had been done for the UCRP of how the fund would have performed over the past ten years had there been no investment in venture capital. Venture capital contributed approximately $1 billion of excess performance, which is a relatively low amount because only a small percentage of the overall portfolio is invested in private equity. Turning to the investment performance for the General Endowment Pool, Mr. Russ commented that active value had been added in U.S. equity through investments with external managers. Private equity was a major contributor during the same time period. A table displaying portfolio market value changes for the year for all investment classes indicates that the current value of the UCRP is $42.978 billion, as compared with $38.8 on December 31, 2003. Beneficiaries were paid approximately $100 million per month. The net change in value for the UCRP was a positive $3.087 billion.

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

Regent Parsky asked how employees who invest in the 403(b) equity fund and the defined contribution plan participate in private equity. Treasurer Russ referred to a display of asset allocation plans and guideline compliance for these two funds, noting the policy target of 5 percent for private equity and the actual investment of 2 percent He confirmed for Regent Parsky that this is the asset allocation that the employees who invest in these plans receive. Employees are also given the opportunity to invest with either Fidelity or Calvert.

In response to a comment by Regent Lee, Treasurer Russ emphasized that the Office is attempting to invest with some of the venture capital firms that have excluded The Regents.

5. **INVESTMENT BENCHMARK DESIGN**

Mr. Tom Richards of Richards & Tierney, The Regents' investment consultant, observed that Webster's Dictionary defines a benchmark as a "standard or point of reference in measuring or judging quality, value, etc." For fund sponsors, the benchmark serves as a way to measure the performance of the fund, which is a fiduciary duty of fund trustees. More specifically, a benchmark is a collection of securities that the fund sponsor would own if it were required to place all of its investments within an asset category in a single, passively managed portfolio. A benchmark portfolio for fund sponsors is a combination of investable market indices weighted in accordance with the fund sponsor's asset allocation policy. A policy benchmark portfolio will facilitate an understanding of the fund sponsor's asset allocation policy and capital market risk. It will serve as the basis of measuring the contribution of the fund's investment management process and the effect of other investment risks that are incurred by the fund. The portfolio benchmark formulates the basis of accountability, responsibility, and authority, which are the critical ingredients of any successful management program. Additionally, it may assist in the implementation of investment management strategies and provide decision-making feedback to fund fiduciaries. A valid benchmark should have the following properties: unambigious, investable, measurable, appropriate, reflective of current investment opinions, specified in advance, and ownership.

In response to a question from Mr. Fisher, Mr. Richards confirmed that if a benchmark is comprised of a list of securities, the investment manager should have formulated an opinion with respect to the attractiveness of these securities.

Mr. Richards observed that it is important to distinguish the difference between an investment benchmark and an investment objective. Invalid investment benchmarks include the following:

- Do good and avoid evil
- Inflation plus five percent

- Top quartile performance

- Superior peer group comparison
- No negative returns
- Outperform the market (Dow Jones Industrial Average)
- Outperform the market (specialized manager vs. S&P 500)

While investment objectives are an important part of a fund sponsor's investment policy, fiduciaries should recognize their limitations but use benchmarks as the necessary tools in the management of a successful investment program. Mr. Richards observed that investment consultants and the investment community in general seem fixated on manager-universe benchmarks. They appeal to the "horse-race" mentality in the investment community and are readily available from traditional suppliers of performance data. These manager-based universes violate most properties of a valid benchmark, they fail to pass quality tests of a good benchmark, and they are useless in manager structuring. The ingredients that contribute to the performance evaluation of a fund sponsor include the specification of the following:

- Approved asset categories
- Allocation percentage targets
- Asset category benchmarks
- Investment managers' benchmarks
- Investment managers' allocation policy
- Effective dates
- Performance accounting detail which allows for the calculation of the returns

In concluding his presentation, Mr. Richards provided an example of how a fund might integrate policy, structure, and performance evaluation. His display listed the actual and policy allocations for a sample client, with appropriate performance benchmarks.

In response to a question from Regent Parsky, Mr. Richards explained that under his scenario the benchmark for alternative assets is the actual performance of the assets. Regent Parsky suggested that this might be a confusing approach because a benchmark serves as one way of evaluating whether the asset class is performing in keeping with its objectives. Mr. Richardson explained that this method provides meaningful feedback to the fund sponsor with respect to these particular assets. The fund sponsor in this case chose not to use the Russell 3000 as a benchmark due to distorted results.

Treasurer Russ noted that The Regents' benchmark for private equity is the Russell 3000 plus 300 basis points. He pointed out that the data he had presented to the Committees had included alternative benchmarks such as Cambridge Associates and the Private Equity Custom Index.

Mr. Martin recalled that the Committees had held several discussions about the appropriate benchmarks for private equity and in particular the difficulty of measuring performance on a quarterly basis. He noted that the methodology used by Richards & Tierney took the private equity component of the aggregate benchmark out of the benchmark equation in order to avoid an artificial bias. Mr. Richards commented that one purpose of his presentation had been to indicate how another fund sponsor had dealt with the issue of alternative investments.

Treasurer Russ proposed scheduling a discussion of illiquid benchmarks and private equity at the May meeting.

While Mr. Fisher agreed that manager-universe benchmarks were not appropriate, he pointed out that for the ten-year period ending in 1989, the Morgan Stanley Capital International FIFA Index had outperformed 95 percent of all managers. Ten years later, 95 percent of the managers had outperformed the index.

6. **UC FOUNDATION ANNUAL ENDOWMENT REPORT FISCAL YEAR 2003-2004**

Treasurer Russ presented the annual endowment report for the UC foundations for the fiscal year ended June 30, 2004. He recalled that for the first time, in 2004 the foundations' assets had been included in the University's financial statements, and he emphasized that the foundations' assets play an important role in the growth of the endowments at the University. The report consolidates performance results from each foundation. The source of the information is the individual foundation, some of which are invested exclusively with The Regents. Mr. Russ reported that in FY 2002-03 the foundations' assets totaled \$1.6 billion, which grew to \$1.93 billion in FY 2003-04. Over the same period, the General Endowment Pool moved from \$4.2 billion to \$4.7 billion, resulting in a total endowment value of \$6.6 billion as of June 30, 2004. The Treasurer highlighted some of the data that are included in the report, including a summary of ten-year foundation investment performance.

Regent Parsky observed that while The Regents has overall responsibility for the safety and soundness of the foundations, historically it has been the policy to allow the foundations to be responsive to the needs of the campus and the donors. He recalled that The Regents had established an asset allocation policy for the assets managed by the Treasurer. This policy should be communicated to the foundations with the request that, if there is variance from the policy, they should so indicate, and why.

Treasurer Russ recalled that Mr. Steve Nesbitt of Wilshire Associates had been formulating a recommended range of targets for the foundations but this was never completed. Several foundations have an asset allocation different from that of the General Endowment Pool.

Regent Parsky saw the need for an annual report to The Regents on variance from the asset allocation policy on the part of the foundations. He believed there should be an independent evaluation of the performance of the foundations by a third party such as State Street. If a foundation is using another agent, there would need to be a mechanism in place for that agent to supply the data to State Street.

Treasurer Russ recalled that his office had volunteered to work with the foundations and with State Street to source the data and create reports; he understood that Regent Parsky was requesting that he proceed with this effort.

Regent Parsky emphasized that the performance data presented to the Regents are not calculated or confirmed by the Treasurer. He believed such a policy should prevail with respect to the campus foundations.

Mr. Taylor assured the Committees that the UCLA Foundation's trustee, the Bank of New York, would provide performance data as needed to the Treasurer within whatever time frame he might establish. He stressed the fact that the foundation members also have fiduciary responsibility for the assets of the foundation.

Mr. Keller noted that because the UC Irvine Foundation uses State Street as its custodian, there would be no problem in providing performance results to the Treasurer. He observed, however, that the foundation staff may need some assistance on how to account for and measure performance statistics. He raised the issue of the expenses incurred by the campuses for such external valuation.

Mr. Child recalled that while at times the UC Davis Foundation had invested all of its capital with the Treasurer, the foundation now wishes to explore a different asset allocation model. The foundation believes that the Treasurer would be able to provide the appropriate investment products and asked whether a custom portfolio could be implemented. Treasurer Russ commented that this would be possible, and Regent Lee supported the proposal.

Regent Parsky confirmed that it would be useful for the Treasurer to produce a quarterly performance report on the foundations for The Regents, using the data provided to State Street. There was concurrence that the cost of transmitting this data should be borne by the University.

In response to a question from Consultant Cambon, Mr. Jesse Phillips, Managing Director of Investment Risk Management, explained that the net investment expenses incurred by the Treasurer in managing all of the assets, including external management fees, had been 2.5 basis points for the year. Treasurer Russ confirmed for Regent Parsky that the number will increase as the move to external managers is completed.

7. **U.S. EQUITY MANAGER SEARCH UPDATE: LARGE CAP**

Mr. Robert Blagden, Managing Director of Externally Managed Investments, provided the Committees with a brief report on the recently completed search for domestic large-capitalization managers. He displayed data on the hiring timeline in days as well as a list of the large capitalization managers who have been hired, the type of fund, the dollars invested, and the fee type. Mr. Blagden noted that 12 of the 15 managers, representing 80 percent of assets, had been assigned to performance-based fees. The average fee is a function of actual performance relative to the benchmark. The average performance-based fee may vary from a 47 percent reduction to a 46 percent increase.

In response to a question from Regent Parsky, Mr. Blagden explained that assets had been allocated to the various managers based upon an understanding of active return relative to the risk that is forecast. Following a further comment by Regent Parsky, Mr. Blagden observed that while these commitments are not short term, on occasion circumstances may dictate a change. To date there had been one manager change in the domestic small-cap equity program as the result of the buy-out of the firm by another firm that chose not to retain the managers that had been hired by the University.

8. **REVIEW OF FIDUCIARY OVERSIGHT AND INVESTMENT OPTIONS FOR THE UNIVERSITY OF CALIFORNIA RETIREMENT SYSTEM DEFINED CONTRIBUTION PLANS**

Senior Vice President Mullinix informed the Committees that UC Human Resources/Benefits and the Office of the Treasurer are collaborating on a long-range, multi-phased project that involves a review of fiduciary oversight, administrative services, and the investment structure and investment offerings available to participants in the University's defined contribution plans–collectively, the Tax-Deferred 403(b) Plan (403(b) Plan), the Defined Contribution Plan (DC Plan), and the 457(b) Deferred Compensation Plan (457(b) Plan) (the Plans). The Plans will need to be amended to implement the recommended changes developed out of this project.

A steering committee has overseen the project to ensure that appropriate fiduciary oversight and due diligence processes are in place and being followed. A number of focus groups have provided feedback from the UC community, and the steering committee continues to consult with key stakeholders, including the University Committee on Faculty Welfare's Task Force on Investments and Retirement. The process has included reviews by external legal counsel and independent consultants with expertise in plan administration and benefit plan investments.

Major project achievements in 2004 included the creation of the 457(b) Plan and the selection of Fidelity Investments Institutional Operations Company to serve as master record keeper for the Plans. The next project milestone is July 2005, which is the target date for the transition of administration of the 403(b) Plan and the DC Plan to a new master record keeping platform and for offering a revised investment structure. The 457(b) Plan is on the Fidelity platform that will be expanded to perform record keeping services for all three plans.

Fiduciary Oversight

Based on consultation with the Office of General Counsel and an independent review by external counsel Orrick, Herrington & Sutcliffe, LLP, the President proposes to amend the Plans to clarify the distinction between primary fiduciary responsibility for investment and administrative functions and secondary fiduciary responsibility, which encompasses ongoing monitoring of the performance of those with primary fiduciary responsibility. Primary authority for investment functions, including the selection and monitoring of asset classes and investment options, is allocated to the Treasurer. Primary authority for administrative functions is allocated to the Associate Vice President–Human Resources and Benefits.

The Regents and the respective Regents' committees retain broad oversight responsibility over both the investment and the administrative functions of the Plans. It is intended that an advisory committee similar to the steering committee that has guided this project will continue to meet on a regular basis to address the overlap between the investment and administrative functions. The committee will include representatives from the Office of the Treasurer, the Division of Business and Finance, the Office of the General Counsel, and external consultants as appropriate. Consultation with the relevant Academic Senate committees and other University constituent groups will continue as in the past.

Review of Investment Options

A goal of the project is to create an investment structure that will allow participants to create investment portfolios by allocating their assets to prudently selected and monitored investment options within a suitable range of asset classes. It is intended that the investment structure will be consistent across the three Plans and will serve as the basis for participant communication and financial education efforts. Through the new master record keeper, participants will be able to view and manage their plan investments on a single platform and use online financial planning and asset allocation tools.

The Treasurer will develop and implement criteria for selecting appropriate asset classes and specific investment options ("Core Funds") within those classes for the Plans after consultation with the new advisory committee and the appropriate constituent groups in the University community. The Treasurer will create and implement a process prudently to monitor and evaluate the Plans' investment structure and the Core Funds, and, based on such periodic evaluations, the Treasurer will make changes to either the asset classes or Core Funds. The Treasurer may choose to use a consultant to support the process. Periodic performance reports will be provided to the Committee on Investments and the Investment Advisory Committee.

In selecting the Core Funds for the Plans, the Office of the Treasurer proposes to follow a process similar to that established for the external manager search for the actively-managed equity portion of the UCRP and General Endowment Pool portfolios. As in the process previously approved, the Treasurer's Office will use quantitative and qualitative assessments.

Summary of Plan Changes

Additional changes to the defined contribution plans that are expected to be recommended to The Regents to support the new administrative platform and investment options include the following:

- Amendments to reflect a new investment structure for the Plans' participants.

- Amendments to reflect the change from monthly to daily valuation of the six UC funds, which will improve participants' ability to perform transactions such as fund transfers, loans, and distributions. Related provisions to prevent short-term or other excessive trading into and out of funds will also be recommended.

- Amendments to expand participants' ability to roll funds over to the Plans. The new master record keeper has the ability to account for additional types of rollovers as required by the Internal Revenue Code.

- Amendments to the 457(b) Plan to expand participant services (e.g., loans) under the Plan.

- Amendments to facilitate the required distribution of accounts of former employees with a balance less than $2,000.

Treasurer Russ described the four-tier structure that will be proposed for UC-managed funds, which was developed in consultation with the Academic Senate's Task Force on Investments and Retirement. For participants who are looking for one-stop shopping and maximum convenience, Tier I will offer pre-mixed investment options such as target horizon funds and the balanced growth fund. Mr. Russ explained that target horizon funds are based upon an individual's age and the assumption for risk tolerance as one progresses through life. The balanced growth fund is based upon the asset allocation plan for the UCRP. Tier II will provide primary asset class funds that will enable participants to construct a diversified portfolio using internal funds which would include the following: equity fund, domestic equity index fund, international equity index fund, bond fund, savings fund, Insurance Company Contract (ICC) fund, and Treasury Inflation-Protection Securities (TIPS) fund. Tier III will offer specialized funds such as a small-cap equity index fund, an emerging markets index fund, a Real Estate Investment Trust (REIT) fund, a variable annuity product, and a socially responsible fund. For participants who wish to be very involved in customizing their portfolios, Tier IV will provide individual mutual funds. Individuals could have as many as 4,000 investment vehicles from which to choose. The Office of the Treasurer will take responsibility for the selection of the funds in Tiers I through III, and a consultant will affirm the decisions.

Senior Vice President Mullinix continued that anyone who invests in Tier IV will have to acknowledge acceptance of full responsibility for the selection of the investment options. The balanced growth fund will represent the default investment option for participants.

In response to a question from Regent Parsky concerning the information being provided to Plan participants, Senior Vice President Mullinix noted that current law had put additional responsibilities on employers who operate their own pension plans. As a result, employers have taken an aggressive stance in providing information to their employees. There will be more planning tools as well as information that will be integrated into the product and be available to participants.

Treasurer Russ reported on the successful implementation of the 457(b) Plan, which has enrolled 6,500 faculty and staff, with 4,500 in its first month.

Mr. Mullinix acknowledged that there had been concerns expressed that Fidelity might attempt to steer investors to its funds. He believed that such marketing had not occurred. Consultant Lehmann agreed and complimented Fidelity's presentation as free of any sales pitch.

Regent Parsky suggested that the Committee be advised on a regular basis that there has been a review of the material that is being provided to employees who invest in the 403(b) or 457(b) funds in order to ensure that the disclosure is adequate. He noted that it may be appropriate to use outside counsel to do so. General Counsel Holst agreed to accept this responsibility. Mr. Mullinix added that the University had been using Orrick Herrington for the process to date.

Regent Parsky stressed that there would be important issues to consider pertaining to the conversion of the defined benefit plan into a defined contribution plan. Senior Vice President Mullinix acknowledged the importance of a defined benefit plan for University employees.

Treasurer Russ pointed out that while the 403(b) and 457(b) Plans are voluntary, employees must contribute to the defined contribution plan.

In response to a question from Regent Parsky as to why a Tier IV option was being offered, Consultant Lehmann explained that it was accepted as common practice to give participants wide choices. Tier IV will be used by a small number of people who wish to direct their own investments, while more than 90 percent of participants are expected to enroll in Tiers I through III.

Mr. Mullinix reiterated the fact that employee contributions to the defined contribution plan are mandatory. He anticipated that, at such time in the future when contributions are required to the retirement plan, the mandatory contributions will be directed there.

9. **PROPOSED INVESTMENT POLICY STATEMENT (IPS) FOR THE GENERAL ENDOWMENT POOL**

The Treasurer recommended that the attached Investment Policy Statement for the University of California General Endowment Pool be approved.

Treasurer Russ recalled that in November 2004 The Treasurer's Office and The Regents' Investment Consultant, Richards & Tierney, had recommended that an Investment Policy Statement (IPS) be approved for the University of California Retirement Plan. The IPS was adopted by The Regents on November 18, 2004.

The origin of this project was the consolidation of all the investment policies that The Regents has approved over the years into a single, coherent document. The objective was to construct a document that would 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 GEP only. It is based on the UCRP IPS and is similar in structure and text, with obvious changes from pension to endowment. Additionally, minor improvements were suggested by Richards & Tierney and the Office of the General Counsel.

Since the asset allocation policy was first adopted in 2000, there has been closer oversight by the Committees and the Office of the President with respect to the operations of the Office of the Treasurer. There is increased complexity in investment strategies as well an increased benchmark sensitivity. The IPS addresses investment policies, including the development of a risk budget and strategic asset allocation, fiduciary oversight procedures, performance objectives, and investment guidelines for each asset class and the general guidelines for all investment managers. There is a focus on the management of risk. 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.

Treasurer Russ explained that the asset allocation for the GEP is the same as that for the retirement plan, but it has wider ranges for the various asset classes. Public equity, bonds, and alternative "interim" allocation remain at 63 percent, 30 percent, and 7 percent respectively. An increase from 25 to 40 percent is recommended for alternative investments, with a corresponding decrease in the lower ranges for public equity and fixed income, from 53 percent to 40 percent for equity and from 20 percent to 5 percent for bonds. The active risk budget will increase from 3 percent to 4.5 percent. Proposed changes to performance benchmarks will be effective for the quarter beginning July 1, 2005.

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 7 percent to plus 10 percent, minus 23 percent. For public bonds, the range increases from plus 5 percent, minus 7 percent to plus 10 percent, minus 25 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.

- Various sub-optimal concentration restrictions are removed from asset class guidelines, which are replaced by the active risk budget for the asset class.

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

Treasurer Russ noted that he plans to follow up with Investment Policy Statements for the 403(b) Defined Contribution Plans and the other funds under his management at a later time.

The Committees went into Closed Session at 3:35 p.m.

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The Committees reconvened in Open Session at 4:00 p.m.

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, Parsky, Pattiz, and Wachter (6) voting "aye."[1]

The Committees returned to Closed Session at 4:01 p.m.

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The meeting adjourned at 4:40 p.m.

Attest:

Secretary