The Regents of the University of California

COMMITTEE ON INVESTMENTS
INVESTMENT ADVISORY COMMITTEE
May 16, 2005

The Committee on Investments and the Investment Advisory Committee met jointly on the above date at the James E. West Alumni Center, Los Angeles campus.

Members present: ***Representing the Committee on Investments***: Regents Anderson, Lee, 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. John Hotckhis, Mr. Charles Martin, Consultants Beim and Cambon

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

The meeting convened at 1:35 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. It was noted that the La Jolla location that had been included in the Notice of Meeting would not be needed for today's proceedings.

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.

A. Mr. Adam Sterling, speaking on behalf of the UC Sudan Divestment Task Force, observed that the Sudanese government relies heavily upon foreign investments for revenue, which it uses to fund genocide in Darfur. He noted that the Committee was being asked to consider an Investment Policy Statement which he believed was insufficient to allow the task force to evaluate what portion of the University's investments are in companies operating in Sudan. The task force requests the University to retain an independent research firm to determine the extent of these investments and that the University divest from any such investments.

B. Mr. Tristan Reed, a student at the Los Angeles campus, estimated that within the non-U.S. equity holdings in the University of California Retirement Plan, the University could have $71.2 million invested in companies doing business in Sudan. The task force asks for full cooperation from the Treasurer in implementing its proposal.

C. Mr. Jared Fox, the president of the UCLA Graduate Student Association, believed that recent fee increases for graduate students were excessive. California will not be successful in the goal to increase the number and quality of health professionals if these fees discourage them from coming to the University. He commented on the fact that graduate students produce revenue for the University as recipients of research grants. Even if the fees are offset by increased financial aid, students will be deterred from pursuing a graduate education. The failure to attract international students will be detrimental to the diversity of the student body.

D. Mr. Edward Alpers, a professor of African history at UCLA and speaking also on behalf of Mr. Michael Garner, Mr. Nathan Lam, and Ms. Sara Novick, presented a brief history of the conflict in the Darfur region of Sudan. Part of the central government's strategy has been to enlist the support of militia forces from among the Arab tribes of Darfur and to transform this political struggle into an ethnically based campaign against the different African peoples of Darfur. According to the United Nations, the resultant human rights disaster has claimed 180,000 lives, while independent sources put the figure at 400,000. Former Secretary of State Powell has declared the situation to be genocide. The students who have organized the UC Sudan Divestment Task Force seek to have the University examine its investment portfolio and withdraw its funds from those corporations that do business with the government of Sudan.

E. Ms. Alexandria Lieben, a first-year graduate student in the School of Public Affairs at the Los Angeles campus, described how the proposed professional fee increase would affect her.

F. Mr. Aravind Moorthy, a graduate student in the School of Public Affairs at the Los Angeles campus, believed that the proposed professional fee increase exceeded what students had expected when they decided to enroll at UCLA. He recalled that the University's departments of public policy had supported the fee increase; however, there is also a consensus that current students should not be affected by the increase.

G. Ms. Michelle Sugi, vice president of academic affairs for the Graduate Student Association at the Los Angeles campus and a second-year graduate student in the School of Public Health, proposed that current professional school students be exempt from the fee increase. A second option would be to implement the increase over a three-year period.

H. Mr. Maciek Kolodziecak, the director of student services for the Department of Public Policy at the Los Angeles campus, read from a letter from Professor Mark Peterson, chair of the department, which states that while the faculty support the introduction of the differential fee, they do not believe that the new fee should apply to continuing students who will be in their second and final year of the program. When students are considering advancing to graduate studies, they make reasonable estimates about the cost and the income they will lose by leaving the job market.

I. Ms. Jeannie Biniek, external undergraduate vice president-elect at the Los Angeles campus, recalled that student government had worked over the past year on a campaign to restore the level of return-to-aid to 33 percent. At the March meeting students met with Regents Lansing and Pattiz to communicate how the reduction to 25 percent is affecting students. Ten legislators have agreed to support the campaign, including Speaker Núñez.

J. Ms. Jenny Wood, student body present-elect at the Los Angeles campus, encouraged The Regents to restore $6 million in funding for financial aid. She reported that Regents Anderson, Lansing, and Pattiz had expressed their support for returning funding for financial aid to 33 percent.

K. Mr. Tommy Tseng, a student at the Los Angeles campus, reported his involvement with the Labor Center, which has served as a connection between the workers of California and the University. Two years ago, Governor Schwarzenegger proposed that funding for the center be eliminated, but this funding was restored by the Legislature. The Governor has proposed no funding be provided in 2005-06. He urged The Regents to support continued funding for the center.

3. **APPROVAL OF MINUTES**

Upon motion duly made and seconded, the minutes of the meeting of February 15, 2005 were approved.

4. **QUARTERLY INVESTMENT PERFORMANCE SUMMARY**

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 a slight negative in the quarter but that the return had been positive for the fiscal year-to-date at 7.24 percent, outperforming the benchmark’s result of

7 percent. Due to the recent adoption of Investment Policy Statements for the UCRP and the General Endowment Pool (GEP), results for the GEP are starting to diverge. Overall the entity, which represents all asset classes, returned 6.56 percent for the fiscal year-to-date and outperformed the benchmark by 62 basis points. Mr. Russ discussed the investment performance of the UCRP based on asset class. Non-U.S. equity returned 16.81 percent and private equity investments 46.64 percent. He reported a total return for the 403(b), 457(b) and Defined Contribution Plans' Funds of 8.23 percent, compared with the benchmark's result of 7.21 percent.

Treasurer Russ briefly discussed the quarterly report on investment risk, noting that total risk is largely related to the allocation between equity and bonds. He presented a graph which indicated active asset exposures for the UCRP as compared with policy as of March 31, 2005. It was noted that, although U.S. equity is 56 percent of the interim allocation, it contributes almost 87 percent of the forecast total risk.

Referring to remarks made during the public comment period, Faculty Representative Blumenthal asked about The Regents' investments in companies doing business with Sudan. Treasurer Russ explained that calculations had found that these investments represent about $66 million, or 0.1 percent of the total portfolio. He expressed his willingness to work with the UC Sudan Divestment Task Force on these issues. He confirmed for Regent Wachter that these companies are in the index fund.

5. **PRIVATE EQUITY BENCHMARKS**

Mr. Jesse Phillips, Director of Risk Management, recalled that the fiduciary responsibilities of the Committee on Investments and the Investment Advisory Committee, as outlined in the Investment Policy Statements (IPS) recently adopted for the UCRP and GEP, include establishing benchmarks for the various asset classes. Benchmarks are used to establish risk preferences and in performance evaluation. Private equity (PE) investments, consisting of venture capital and buyout funds, are unique among asset classes in that there are no market indices which can serve these two purposes. This fact results from the absence of a "market," that is, a recognized and agreed-upon universe of investment opportunities for PE fund managers. In addition, performance measurement for PE funds differs from that of traditional stock and bond portfolios. The performance for PE funds is stated as an internal rate of return (IRR), which is not comparable to the "time weighted" rates of return used for market indices and traditional portfolios. Because a PE fund's performance is not known until the end of its life, short-term comparisons of PE "returns" with either various market indices or peer group percentiles are misleading and aid in neither performance evaluation nor decision making. The valuation of the assets within a fund is often done subjectively, using conservative accounting principles, and there is no universal standard for how private equity fund managers should value these assets at any given time.

The Regents recognized these reasons and, in the newly adopted IPS for the UCRP and the GEP, eliminated the former private equity benchmark (Russell 3000 plus 300 basis points, lagged three months) as a metric for short-term performance evaluation, while recognizing that over the long term, investments in PE are evaluated against the returns available in the public equity markets.

In investment management, benchmarks serve as a standard of measurement and help the investor and manager to determine if the management process has created value, after adjusting for risk. The use of a benchmark assumes that there is an investable alternative to the active fund. The properties of a benchmark that were presented to the Committee by Richards & Tierney, The Regents' investment consultant, at the February meeting have been incorporated into the Investment Policy Statements for both the UCRP and the GEP. Asset managers are expected to select securities from a recognized market, take active risk relative to the market, and provide returns in excess of passive alternatives. All of the benchmarks used by the Treasurer's Office meet these criteria.

Mr. Phillips discussed time-weighted versus dollar-weighted returns and outlined the three criteria for using time-weighted returns:

- The investments are liquid enough so that performance is unaffected by cash flows.
- The manager controls the inflows and outflows.
- Market-based pricing for valuation exits.

Because marketable securities meet these criteria, the use of time-weighted returns is the industry standard. Private equity does not meet these criteria; therefore, the use of IRRs is mandated by the CFA Institute Global Investment Performance Standards. Measuring the performance of private equity depends on timing and the amount of cash flows, which are determined by the manager, not the investor. It also depends on interim valuations of unrealized business opportunities, which are necessarily subjective. Because performance is not really known until the fund is terminated, interim results may be meaningless. There is no industry standard on methods of valuation for private equity, and most investments are held at cost until an evaluation event occurs. Opportunities vary across time, so funds from different vintage years are not directly comparable.

Mr. Phillips presented the conclusion that there are no benchmarks, in the sense of the criteria outlined above, that are appropriate for private equity. Market movements only weakly affect private equity valuations, especially over short periods of time. He presented graphs which illustrated the relationship between public and private equity over longer time periods.

Treasurer Russ confirmed for Regent Parsky that the intention of the presentation was to underscore the need to rethink the way in which results for private equity had historically been presented to The Regents. He recalled that in 2003 a new format was introduced for reporting private equity results by comparing peer groups.

Mr. Tom Richards of Richards & Tierney commented on the distortions that occur when returns for private equity are compared with traditional benchmarks such as the Russell 3000. It is more appropriate that the benchmark for private equity be its own return. He stressed that results for this investment category would continue to be evaluated on an ongoing basis.

Regent Parsky suggested that there should be an analysis of why private equity was selected as a category to be included in the overall portfolio. He observed that many of the University's peer institutions had invested a greater portion of their portfolio in private equity. Treasurer Russ noted that the goal for the UCRP was five percent; $600 million to $800 million in commitments are made each year. For the GEP, the goal was increased to ten percent, but this is difficult to reach because of the current sellers' market and the negative results from the loss of the public records act litigation.

Regent Wachter believed that there were issues to be addressed in addition to the question of whether The Regents should invest in private equity. He agreed that it was not possible to measure performance on a quarterly basis. His philosophy was that one should evaluate whether investing in private equity produces results superior to public equity over the long term. A second issue is the choice of investments, which often may be made on the basis of the fund's past performance and the people who are involved. Regent Wachter suggested that it would useful for the Treasurer to present data that would demonstrate the value of investing in private equity, given the loss of liquidity. He supported the effort to bring the allocation to private equity in the UCRP to five percent. He noted the importance of building relationships with venture capital firms, as private equity funds are tailored to institutions.

In response to the comments made by Regents Parsky and Wachter, Treasurer Russ noted that the ten-year performance for the Russell 3000 had been 11 percent, while private equity had returned 30 percent for The Regents' various portfolios.

Mr. Martin pointed out that the higher allocation to private equity by peer institutions such as Harvard and Yale should indicate to The Regents the desirability of these investments. The University of California should be one of the top choices of investors for venture capital firms. He offered to work with the Treasurer's Office to develop an annual report on private equity.

In response to a question from Consultant Cambon, Treasurer Russ explained that the IRRs for private equity are provided by Cambridge Associates. The report to the Committees consists of total returns. Valuations are included in the quarterly report. Treasurer Russ noted that, as detailed in his letter to the Committees, Senate Bill 439, Alternative Investments Disclosure legislation, is moving rapidly through the State Senate.

Regent Parsky asked that the analysis to be provided by the Treasurer include an assessment of the value of investing in venture capital versus buy-outs.

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 2004 the Treasurer's Office and Richards & Tierney had recommended that the Committee on Investments approve a new Investment Policy Statement (IPS) for the University of California Retirement Plan. The IPS was adopted by The Regents on November 18, 2004.

In February 2005 the Treasurer's Office and Richards & Tierney recommended that the Committee on Investments approve an IPS for the General Endowment Pool, which was adopted by The Regents on March 17, 2005. This latter document was closely modeled after the recently approved IPS for the UCRP, with small changes recommended by the Office of the General Counsel and Richards & Tierney to clarify responsibilities.

This proposed IPS for the UCRP differs from the policy approved in November 2004 only insofar as it incorporates the modifications and clarifications that were made to the GEP IPS. It should be considered a housekeeping change only, but one which will permit the UCRP to use the same strategies and managers as permitted in the GEP.

There are no proposed changes to performance benchmarks, asset allocation, or risk budgets.

Treasurer Russ indicated 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.

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

7. **REGENTS DISCLOSURE POLICY FOR INVESTMENT RELATED INFORMATION FOR THE TREASURER'S OFFICE**

The Treasurer recommended that the attached Disclosure Policy Statement for the University of California Retirement Plan and General Endowment Pool investment information be approved.

Treasurer Russ explained that the proposal to establish a disclosure policy on investment-related information for the University of California Retirement Plan and General Endowment Pool will allow the Treasurer's Office to respond efficiently and appropriately to the number of requests it receives from participants and the public. Currently, he provides investment-related information on the UCRP and GEP to The Regents consistent with the requirements outlined in the Investment Policy Statement for the University of California Retirement Plan approved by The Regents on November 18, 2004 and the Investment Policy Statement for the General Endowment Pool approved by The Regents on March 17, 2005. Materials presented in the open session portions of the joint meetings of the Committee on Investments and the Investment Advisory Committee, including the Quarterly and Fiscal Year Investment Performance Summary and Risk Report, are posted to a publicly accessible website. The Treasurer's website also makes available the private equity internal rates of return as required by a recent court ruling against The Regents. Treasurer Russ commented that, despite the availability of such comprehensive information, his Office continues to receive requests for more detailed data. These requests raise two concerns. First, providing extensive and/or proprietary information increases the risk that he will not be able to negotiate with, hire, and retain the most effective investment managers for the UCRP and GEP. Investment managers develop unique portfolio strategies which they view as proprietary information. Detailed listings of the assets within a particular sector can indirectly reveal the key components of such a strategy.

Second, responding to detailed requests absorbs a considerable amount of administrative time. The Treasurer's Office is not staffed to handle a large volume of requests for detailed information in a timely and complete manner. While the administrative issues could be addressed with more people, it is not clear that would be an appropriate use of resources, particularly with respect to the UCRP.

Treasurer Russ noted that, with the proposed policy in place, he will be able to direct people to the website for the current and historical information on the UCRP and GEP that the Treasurer can disclose, consistent with the policy. Having ready access to this type of comprehensive data is likely to satisfy most people. Those who want more extensive information will need to submit a request for existing documents under the Public Records Act.

The proposed policy is also intended to increase the consistency of the Treasurer's responses. It has been drafted with the assistance of Orrick, Herrington & Sutcliffe LLP and is based on the disclosure requirements in the Employee Retirement Income Security Act of 1974 that apply to private employer plans.

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

8. **ADOPTION OF EXPENDITURE RATE FOR THE GENERAL ENDOWMENT POOL**

The President recommended that the Committee on Investments concur with the recommendation to the Committee on Finance that the expenditure rate per unit of the General Endowment Pool for expenditure in the 2005-06 fiscal year shall be 4.65 percent of a 60-month moving average of the market value of a unit invested in the GEP.

Assistant Vice President Barber recalled that in October 1998 The Regents had adopted a target endowment expenditure rate of 4.75 percent, with a first-year payout of 4.35 percent. For all future years, the President and the Treasurer committed to review GEP performance, inflation expectations, and the University's programmatic needs and to recommend to The Regents a rate that would provide appropriate increases in the dollar value of the payout. The payout will be distributed in August 2005 for expenditure in the 2005-06 fiscal year. This would increase by five basis points the rate adopted by The Regents in May 2004 for expenditure in the 2004-05 fiscal year.

If the GEP achieves the total return of 7.5 percent for the full 2004-05 fiscal year, the recommended rate of 4.65 percent would produce an increase per share payout for expenditure in 2005-06 of 1.18 percent over the prior fiscal year. For the first nine months of this fiscal year, ended March 31, 2005, the GEP has experienced a total return of 7.88 percent. Inflation as measured by the Consumer Price Index has been running at about 3 percent over the past year. The President and the Treasurer will continue to review annually the expenditure rate in the context of the performance of the GEP to form their recommendation to The Regents for the continuation or modification of the endowment expenditure rate.

The Attachment provides estimates, in dollar terms and year-to-year percentage change of GEP, for payouts based on a range of assumed GEP investment returns through the end of fiscal year 2004-05, the end of the 60-month averaging period. This range of dollar payouts is considered to be an appropriate balance among the following objectives that were discussed with The Regents in October 1998:

- Maximize long-term total return;
- Preserve the real (after inflation) long-term purchasing power of the endowment portfolio's principal and of its distributions;
- Optimize annual distributions from the endowment portfolio;
- Maximize the stability and predictability of distributions;

- Promote accountability of asset management (disclosures to donors, performance reporting, etc.); and
- Promote the fundraising effort.

It was noted that the number of shares to which the payout formula applies changes over time. New shares are purchased by additions to the GEP, existing shares experience fluctuation with the financial markets, and some shares are sold. For these reasons, the percentage is expressed on a per-share basis.

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

The Committees went into Closed Session at 3:15 p.m.

. . . .

The meeting adjourned at 4:15 p.m.

Attest:

Secretary