The Regents of the University of California

COMMITTEE ON INVESTMENTS
INVESTMENT ADVISORY COMMITTEE
August 16, 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; Press Room, Morgan Center, Los Angeles campus; and 5200 Blue Lagoon Drive, Suite 790, Miami, Florida.

Members present: ***Representing the Committee on Investments***: Regents Blum, Lee, Parsky, Preuss, and Wachter; Advisory member Schreiner

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

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

The meeting convened at 1:30 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 person addressed the Committees.

Professor Emeritus Charles Schwartz proposed that quarterly reports from the Office of the Treasurer contain data on assets held and performance for each individual investment manager engaged by the University. Annual reports should also contain data on management fees paid to each individual external manager as well as a listing of commissions paid to all brokers. He believed that such information would have to be produced in response to a request under the California Public Records Act.

3. **QUARTER AND FISCAL YEAR PERFORMANCE AND RISK REPORT**

In accordance with the Schedule of Reports, the Quarter and Fiscal Year Performance and Risk Report for the second quarter 2005 was submitted for discussion. Interim Treasurer Berggren commented that the University of California Retirement Plan (UCRP) had returned 2.85 percent versus a benchmark return of 2.93 percent. For the fiscal year, the UCRP return was 10.30 percent versus the policy benchmark of 9.82 percent. Four areas contributed to this performance: active U.S. equity security selection, non-U.S. asset allocation, emerging markets asset allocation, and private equity. For the fiscal year, the General Endowment Pool (GEP) returned 10.31 percent versus the policy benchmark of 9.45 percent. The underweight in fixed income, which underperformed, helped to minimize the impact on performance. Principle contributors to the performance for the GEP were active U.S. equity selection, emerging markets, asset allocation, and private equity. The absolute and relative returns for private equity were outstanding for almost all time periods.

In response to a question from Regent Parsky, Interim Treasurer Berggren reported that currently 70 percent of the portfolio is invested passively. Regent Parsky observed that as the Treasurer's Office moves towards more active managers, the benchmarks will become more meaningful.

4. **EXTERNAL EQUITY MANAGER SEARCH UPDATE**

Mr. Robert Blagden, Managing Director of Externally Managed Investments, reported that the Treasurer's Office had recently completed the search for the external managers for non-U.S. equities. Mr. Blagden recalled that the asset allocation guidelines call for a blend of passive and active strategies; for non-U.S. equity, the passive component invests in developed countries, while the active component invests in developed and emerging countries. He commented on the organization of the Externally Managed Investments Group, which currently has two open positions. Recruitment is under way for the senior analyst position. Mr. Blagden commented on the way in which the external manager Requests for Proposals are reviewed in the Treasurer's Office; the process includes a meeting with the finalists for their presentations. The finalist managers are selected by the Treasurer's Office, with outside review by Richards & Tierney, The Regents' investments consultant. Following fee and contract negotiations, the Office funds the external managers. Performance fees are paid in two equal installments for the first two annual computations.

Mr. Blagden presented a chart which displayed the time lines for the RFPs for the external managers of small-cap domestic equity, large-cap domestic equity, and non-U.S. developed equity. He noted that to date $8.5 million had been invested with 35 managers. A chart of non-U.S. developed market managers listed the managers hired, the number of dollars invested with each, and the fee type. Of the eleven managers, five are located outside the United States. Most of the negotiated fees are performance based, and the managers are appropriately balanced between growth and value. The fees are asset-based for three of the eleven managers; the account sizes vary from $145 million to $311 million. The remaining eight managers are paid a fee that is a function of actual performance relative to the benchmark.

Mr. Blagden outlined the next steps relative to externally managed investments. The portion of assets which is managed actively will be increased both by adding additional assets to existing managed portfolios and by funding new portfolios. Decisions regarding the shift of passive assets to active space will be approved by the Treasurer's Office. The Risk Management group will review investment guidelines and portfolio characteristics. The active risk exposures created by the total manager structure will be within guidelines established by the risk budget. The proposed investments will be approved by the Treasurer, and Richards & Tierney will be advised of new managers and new strategies to be implemented by existing managers. Richards & Tierney will confirm to the Treasurer that the new manager and/or new strategy is appropriate, given the portfolio and the investment policy guidelines. Manager rebalancing will be executed on a periodic time frame. Investment performance results will be reported to the Committee in accordance with the normal quarterly reporting cycle.

In response to a question from Mr. Martin, Mr. Blagden explained that there had been an overweight in emerging markets. Once the Treasurer's Office is able to evaluate how the non-U.S. developed managers are performing, it will reexamine the concept of how much to invest in emerging markets and with which managers.

In response to a question from Regent Parsky, Mr. Blagden noted that the goal of the program is to add value to the portfolio. There are no guidelines with respect to the percentage of active versus passive portfolios, but he anticipated that it would increase to at least 50 percent.

Mr. Fisher asked about the performance-based fees. Mr. Blagden responded that it had been the decision within the Treasurer's Office to pay the managers' fees based upon performance because this system aligns the University's interests with those of the managers more than a traditional asset-based fee. Mr. Fisher emphasized that his firm treats all of its clients the same; he did not believe that a performance-based fee was preferable. Mr. Blagden recalled that in the decision process the Treasurer's Office had been conscious of whom it was hiring and what they could produce. Each manager fee arrangement was carefully crafted to be no worse than a traditional one, and so far this system has worked well.

Mr. Martin observed that the ability to invest more money actively was driven by the quality of the managers and their capacity to take on new clients, and he asked Mr. Blagden for his comments. Mr. Blagden recalled that, during the second RFP, the Treasurer's Office became concerned about one of the managers that had been retained during the first RFP; that firm was dismissed. The intention will be to continue to identify potential managers and to invest with them as expediently as possible.

In response to a comment by Regent Parsky regarding the involvement of Richards & Tierny in the RFP process, Mr. Blagden explained that Richards & Tierney is given the opportunity to evaluate the choices made by the Treasurer's Office. This assessment is provided in writing.

5, **GENERAL ENDOWMENT POOL ASSET ALLOCATION AND BENCHMARKS**

The Interim Treasurer recommended and Richards & Tierney concurred that the attached Asset Allocation and Benchmarks for the University of California General Endowment Pool (GEP) be approved.

As of 2005 fiscal year end, this transition was partially completed, and the Interim Treasurer recommended and Richards & Tierney concurred that The Regents:

- formalize the current asset allocation as the new policy allocation;
- modify the ranges around policy weights;
- modify certain of the asset class benchmarks; and
- modify the total fund benchmark to be consistent with the proposed allocation as detailed in the proposed changes to Appendix 1 of the GEP Investment Policy Statement.

These changes are to be effective on October 1, 2005.

Interim Treasurer Berggren recalled that in February 2005 the Committees had discussed the asset allocation for the GEP; an Investment Policy Statement was adopted by The Regents at its March 2005 meeting. The policy asset allocation was consolidated into three broad categories: equity, fixed income, and all alternatives. Although the Committee asked the Treasurer to move the GEP asset mix closer to peer institutions, a new asset allocation policy was not formally adopted at that time. Ms. Berggren displayed a graph showing the GEP asset transition during the period March to July 2005. During this period, U.S. equities were reduced by $786 million; bonds were reduced by $250 million, and Treasury Inflation Protected Securities (TIPS) were increased by a comparable amount as a bond substitute. One hundred forty-eight million dollars were moved into absolute return, and $172 million were moved into emerging markets equity. As of 2005 fiscal year end, the transition to a "peer median" asset allocation was partly completed. The alternative asset class was partially funded, but there is still an overweight in U.S. equity and bonds and an underweight in absolute return. Interim Treasurer Berggren discussed the proposed changes to the policy as shown in the attachment. The shift in asset allocation improved the risk-return trade-off; however, the University is still below the Cambridge Median. The intention is for the endowment to mirror its comparable universe.

In response to a question from Regent Wachter, Ms. Berggren explained that the two percent allocation to private equity had been made in recognition of the fact that it has been difficult to achieve the five percent target allocation. The principle issue with respect to private equity is the fact that the distributions have more than offset the commitments. There were few investments made between 1998 and 2002. Many of the investments that were made in 2002, when the focus was on buy outs, are producing good returns, which is unusual. Ms. Berggren pointed out that the Treasurer's Office has been very selective in terms of the groups and sectors that it has invested with. She confirmed for Regent Wachter that at present the policy allocation to absolute return is 10 percent. A future recommendation to the Committee will propose increasing this allocation to 20 percent.

Regent Parsky observed that the amendments to the policy are intended to change the way in which performance is measured. He believed that it would be important for the Committee to revisit this policy periodically.

In response to a comment by Committee Chair Lee regarding the desirability of attaining the five percent target for private equity, Regent Blum pointed out that in the current market private equity funds have more money than they can place. As a result, they are accepting limited amounts of committed capital. He supported the Interim Treasurer's policy of caution in this area.

Mr. Martin raised the issue of diversifying the fixed-income portfolio to include high-yield and non-U.S. investments. Interim Treasurer Berggren confirmed that this strategy was part of the overall investment plan. Mr. Martin observed that, while there should be major exposure to real estate in the portfolio, investments are difficult given the current market.

Regent Wachter pointed out that it was not unusual for institutions to invest directly in real estate. Regent Parsky noted that, as this strategy is not part of the guidelines, there would be a need for further discussion. The capabilities that would be required with respect to staff would be very different from what is now being contemplated. He stressed that the Treasurer's Office is having difficulty recruiting staff to select real estate managers.

Returning to her presentation, Interim Treasurer Berggren recalled that new benchmarks have been proposed for the developed and emerging non-U.S. equity classes. In addition, a new asset class benchmark has been added for TIPS, and the fixed-income benchmark has been changed for the Citigroup Large Pension Fund Index to the Lehman Aggregate Bond Index. This replicates a duration that is more appropriate for an endowment.

Upon motion duly made and seconded, the Committee approved the Interim Treasurer's recommendation and voted to present it to the Board, Regents Blum, Lee, Parsky, Preuss, and Wachter (5) voting "aye."[1]

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

6. **ABSOLUTE RETURN STRATEGIES INVESTMENT GUIDELINES**

The Interim Treasurer recommended and Richards & Tierney concurred that the attached Investment Guidelines for Absolute Return Strategies for the University of California General Endowment Pool be approved. These changes are to be effective immediately, except for the change in the performance benchmark, which will be effective October 1, 2005.

Interim Treasurer Berggren explained that the proposed guidelines would replace the existing five permitted strategies with four broad groupings that are consistent with industry practice.
The proposal will change two existing guidelines and add two new risk guidelines and will modify the performance benchmark to be consistent with capital market forecasts. The existing absolute return guidelines were implemented in 2003 for an endowment portfolio that had a five percent allocation. These strategies were long/short equity, market neutral equity, convertible bond arbitrage, risk arbitrage, and distressed securities. They were intended to provide consistent returns and low volatility. The current allocation is almost at 10 percent of the GEP, and it is appropriate to expand the list of permissible investment strategies to allow for a more diversified portfolio and to maintain low volitility.

Ms. Berggren continued that she is recommending that the permitted strategies be restructured into four main categories, with each encompassing several underlying sub-strategies. This allows managers to change tactical allocations when necessary to exploit opportunities. The proposed four categories, with their weights and ranges, are as follows:

	Weights	Ranges
• Long/Short Equity	35%	0-70%
• Event Driven	30	0-70
• Relative Value	30	0-50
• Opportunistic	5	0-20

The revised guidelines are intended to reduce concentration and to manage risk. No investment with any single manager may represent more than 15 percent of the total AR portfolio, and no investment with any single manager may exceed 15 percent of that manager's total assets under management. The new guidelines are intended to ensure diversification and to manage risk. No more than 10 percent of the total AR portfolio may be invested in dedicated non-U.S. strategies, and no more than 15 percent of the total AR portfolio risk may be derived from any single manager. Finally, it is recommended that the performance benchmark be modified to reflect the level of systematic risk in the portfolio and to be consistent with the Treasurer's capital market assumptions. The current benchmark is one-month T bills + 450 basis points; adoption of a lower threshold of one-month T bills + 200 basis points is recommended, effective October 1, 2005.

Regent Parsky asked about the relationship between the consultant and the AR staff in the Treasurer's Office. Ms. Berggren explained that they work closely together, meeting on a weekly basis to review any changes that are occurring within the absolute return universe. The goal is to invest with top managers. Regent Parsky observed that absolute return is an evolving area; there is a need for care in terms of manager selection. Ms. Berggren confirmed that the consultant performs due diligence for all the managers with whom the Treasurer's Office intends to invest.

In response to a question from Regent Wachter regarding the benchmark for this asset class, Interim Treasurer Berggren observed that absolute return investing is similar to private equity in that there are objectives rather than real benchmarks. The objective of the absolute return strategy portfolio is to earn an annualized return that exceeds the annualized rate of return of Treasury bills by two percent. The intention is to turn the portfolio around such that a new benchmark may be established within the next year. Regent Wachter suggested that investing in this asset class should be evaluated in terms of reward versus risk. Regent Parsky observed that the Committees should not send an inappropriate message to the staff to increase commitments to more risk-oriented strategies in order to compete with the benchmark. Inherent in the benchmark is the policy of moving some money from fixed income into this class, because the benchmark is a measure of performance in the fixed-income category. Mr. Martin stressed that one motivation for investing in absolute return is to diversify the portfolio. Regent Wachter pointed out that the absolute return strategy is not similar to investing in fixed income.

Mr. Fisher asked about the fees paid to absolute return external managers. Ms. Berggren explained that the Treasurer's Office pays whatever they charge, because this market is similar to private equity in that it is difficult to invest. Mr. Fisher observed that there is more demand for hedge-fund managers than there are qualified managers. Ms. Berggren pointed out that the strategy for The Regents' portfolio is to identify managers with a broad range of capabilities.

Regent Parsky agreed that creating more flexibility seemed appropriate, as does adjusting the benchmark for a period of time. He expressed some concern about the ability to invest up to 15 percent of the AR portfolio with a single manager, especially in light of the difficulty involved in investing with high-quality managers.

Regent Blum pointed out that the recommendation includes ranges of zero to 70 percent for two of the proposed categories of investments. Regent Parsky observed that an appropriate level of flexibility should be provided to the staff. Mr. Fisher believed that knowing the external mangers well served to reduce risk. It was his opinion that investing 15 percent of the AR portfolio with one manager was appropriate, as was the requirement that no investment with any single manager may exceed 15 percent of that manager's total assets.

Regent Lee expressed concern about the proposed ranges. Interim Treasurer Berggren recalled that these ranges had already been approved by The Regents. She noted that it is important to have the ability to take advantage of attractive opportunities. Regent Lee believed that such a wide range was meaningless.

Regent Parsky pointed out that these ranges were put into place when there was no money committed to absolute return. Ms. Berggren believed that these ranges were currently necessary. Regent Parsky suggested the need to reexamine these targets on a regular basis as the program matures.

Mr. Martin noted that the absolute return industry was in a transition; The Regents is arriving at this asset category about ten years too late. He expressed confidence in the fact that the staff in the Treasurer's Office who are responsible for this area are experienced.

Upon motion duly made and seconded, the Committee approved the Interim Treasurer's recommendation and voted to present it to the Board, Regents Blum, Lee, Parsky, Preuss, and Wachter (5) voting "aye."[1]

7. CONFLICT OF INTEREST POLICY

The Interim Treasurer recommended and Richards & Tierney concurred that the following Conflict of Interest Policy for all assets managed by the Treasurer of The Regents of the University of California be approved:

> The Regents has adopted Investment Policy Statements for the University of California Retirement Plan and General Endowment Pool, which assign limited roles and responsibilities to investment fiduciaries, with appropriate checks and balances.
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> The existing governance process has avoided the potential for and the appearance of conflicts of interest, with respect to the selection of individual investments or investment managers, by maintaining a separation of roles and responsibilities.
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> The Regents' Committee on Investments, with advice from the Investment Advisory Committee, is responsible for oversight of the management of investments on behalf of The Regents. This involves the establishment of investment policies and oversight of the management of the assets. These responsibilities include approving an asset allocation policy, performance benchmarks, risk budgets, and investment guidelines.
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> The Treasurer is responsible for implementing the approved investment policies and the development of investment processes and procedures for asset allocation, risk management, investment manager selection and termination, allocation, monitoring and evaluation, and the identification of management strategies that will improve the investment efficiency of the Fund assets.

In order to maintain the highest fiduciary standards and to continue to comply with institutional investment best practices, this Policy explicitly separates the roles and responsibilities of various UC fiduciaries to ensure the continuance of sound investment practice and the protection against real or perceived conflict of interest, especially with regard to the selection of individual investments or investment managers. By separating the duties of investment policy-making and investment implementation, The Regents' Committee on Investments has created an institutional framework to uphold the California Political Reform Act of 1974, which provides that public officials shall not make, participate in making, or influence a governmental decision in which the official has a financial interest.

Interim Treasurer Berggren explained that the Policy on Conflict of Interest should be incorporated into the University's investment policies in order to ensure the highest fiduciary standards for the management of The Regents' assets. The Regents, University officials, and members of the Investment Advisory Committee are require to comply with the California Political Reform Act of 1974. A conflict of interest policy is consistent with institutional investment management best practices. The existing governance process has avoided the potential for and the appearance of conflicts of interest. This is achieved by maintaining the separation of roles and responsibilities between The Regents and the Treasurer. Ms. Berggren stressed that no Regent had ever influenced a decision made by the Treasurer's Office. In response to a comment by Regent Blum, she added that policy would not prevent a Regent from offering advice.

Upon motion duly made and seconded, the Committee approved the Interim Treasurer's recommendation and voted to present it to the Board, Regents Blum, Lee, Parsky, Preuss, and Wachter (5) voting "aye."[1]

8. **ANNUAL INCENTIVE PLAN RECOMMENDED CHANGES FOR FY 2006**

The President recommended that the incentive program asset class investment performance objectives be modified as indicated in Attachment "C" - Performance Objectives."

Interim Treasurer Berggren explained that the recommendations for FY 2005-06 call for the development of standards for the Insurance Company Contract (ICC) Fund and the modification of some of the existing standards for non-U.S. equity. In addition, the entity performance standards will be modified due to the changed scope of active management. Mercer Human Resource Consulting has endorsed the proposed changes. For the 403(b) ICC Fund, the performance objective is the five-year Treasury note, with the same performance targets as the Short Term Investment Pool and the 403(b) savings and bond funds. With respect to the non-U.S. sector, the developed and emerging markets have been separated; it is appropriate to have performance standards for these two segments. For the developed sector, the objective will be the MSCI World ex U.S. index. For the emerging markets the recommendation is the MSCI Emerging Market Free Index. The change in the entity standards reflects a modest increase in the scope of active management. In November 2003 The Regents modified the target for entity performance to reflect the elimination of the internal active equity program and the reduction of actively managed assets from 81 percent to 46 percent. It was agreed that entity targets would be reviewed when active equity program implementation was complete and if the active proportion of the U.S. and non-U.S. equity increased. Ms. Berggren outlined the three changes that occurred during FY 2005 which resulted in the requirement to review the targets:

- Actively managed U.S. equity increased from zero to 25 percent in the UCRP and the GEP.

- Actively managed non-U.S. equity increased from zero to 50 percent.

- Private equity has moved into a passive position.

The last change almost offsets the effect of the first two.

The recommendation for entity performance targets is for FY 2005-06 only.

Mr. Terry Dennison of Mercer Human Resource Consulting confirmed that Mercer had concluded that the proposed benchmarks meet the standards for industry best practices.

Upon motion duly made and seconded, the Committee approved the Interim Treasurer's recommendation and voted to present it to the Board, Regents Blum, Lee, Parsky, Preuss, and Wachter (5) voting "aye."[1]

The Committees went into Closed Session at 3:00 p.m.

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The meeting adjourned at 4:05 p.m.

Attest:

Associate Secretary