The Regents of the University of California

COMMITTEE ON INVESTMENTS
INVESTMENT ADVISORY COMMITTEE

February 14, 2006

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; Buehler Alumni and Visitors Center, Davis campus; and 5200 Blue Lagoon Drive, Miami, Florida.

Members present: ***Representing the Committee on Investments***: Regents Lee, Parsky, Pattiz, Preuss, Rosenthal, and Wachter; Advisory member Oakley

***Representing the Investment Advisory Committee**:* Regents Lee and Pattiz, Senior Vice President Mullinix representing President Dynes, Mr. David Fisher and Mr. Chuck Martin; Consultants Behrle, Child, Lehmann, and Thomas

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

Representing the campus foundations: Mr. Rick Keller, University of California, Irvine Foundation

The meeting convened at 1:30 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' agendas.

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 concerning the items noted.

Item 608, Status of Divestment from Sudan

A. Mr. Adam Sterling, co-chair of the UC Sudan Divestment Task Force and speaking also for Ms. Sheila Breeding and Ms. Jeannie Biniek, expressed the task force's appreciation for the action taken by The Regents at the January meeting establishing a study group and reported that substantial progress had been made with respect to the development of a Sudan divestment policy. He recalled that Regent Lee had commented at the January meeting on potential negative effects on the citizens of that country resulting from divestment. The task force feels that the targeted divestment policy being pursued and analyzed by the study group may alleviate many of Regent Lee's concerns, as it excludes any company that provides goods or services that benefit the population of Sudan, including agriculture-related business. Because agriculture remains Sudan's most important economic sector, exclusion of agriculture from divestment is critical to minimizing any harm to citizens. Targeted divestment also considers whether a company has expressed concern over Darfur and implemented a pro-active corporate ethics policy. The study group's goal is to include those companies deemed an important source of government revenue. According to the International Monetary Fund, after oil drilling began in Sudan in 1999, foreign investment began to rise, creating a surplus in government revenue that has led directly to the growth of the country's military.

B. Ms. Karina Garcia, legislative director for the UC Sudan Divestment Task Force and speaking also for Mr. Shahaf Tuler and Ms. Julliete Jardim, read from a list of elected officials who support UC divestment from Sudan. The task force has moved forward with a political campaign to assist in providing indemnification for the Regents, which would protect former, present, and future Regents, Officers, employees, and investment managers from all claim demands, suits, actions, damages, judgments, costs, charges, and expenses resulting from any decision not to invest in targeted firms with business operations in Sudan or with the Sudanese government.

C. Ms. Jenny Wood, president of the ASUCLA and speaking also for Ms. Baylee DeCastro and Ms. Ruth Dawson, commented on the large number of supporters of divestment within the UC system, including unions and student governments. The UCLA Alumni Association recently passed a resolution in support of divestment. The resolution will be shared with the other alumni associations across the system, and they will be encouraged to adopt similar resolutions. The UCLA Alumni Association will send a link to the online petition to all of its members.

D. Mr. Michael Garner, a member of the UC Divestment Task Force and speaking also for Ms. Tracy Shibata, Mr. Arek Santikian, and Mr. Matthew Sablove, observed that China and Russia, along with other countries with corporations doing business in Sudan, are preventing international action from taking place, especially in the United Nations Security Council. Because the Khartoum regime has a history of responsiveness to economic pressure, targeted divestment is a potentially effective tool. The task force believes that any targeted divestment should be lifted once the behavior of the Sudanese government improves. Mr. Garner suggested that the University of California stands at a critical juncture in the national movement of targeted divestment. Educational institutions lack the resources necessary for

Sudan-free investments. A decision to pursue targeted divestment would assist state and university campaigns that are looking to UC for action.

E. Ms. Katie Tokushige, a co-chair of the Darfur Action Committee at UCLA, noted that the divestment study group had been asked to present The Regents with a set of divestment options in March. The UC Sudan Divestment Task Force recognizes that the Regents may have questions that will not be addressed in the study group's report. One such question would be Regent Lee's concern that certain types of divestment may harm the country. She asked that the Regents inform the task force of any issues that it should research.

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

Upon motion duly made and seconded, the minutes of the meeting of November 14, 2005 were approved, Regents Lee, Parsky, Pattiz, Preuss, and Wachter (5) voting "aye."[1]

4. **QUARTERLY INVESTMENT PERFORMANCE SUMMARY**

Interim Treasurer Berggren reported that investment performance for the quarter ended December 31, 2005 was positive on both an absolute and relative basis, with a return of 1.96 percent for the University of California Retirement Plan (UCRP) and 2.47 percent for the General Endowment Pool (GEP). The U.S. equity portfolios continued with another positive quarter due to solid economic gains and low inflation, while the non-U.S. equity portfolios increased in excess of 16 percent for both the fiscal year-to-date and the one-year period. The fixed income portfolio had excellent performance for all time periods. Asset allocation accounted for the good performance over all periods, with an underweighting in fixed income and a slight overweighting in emerging markets. The annualized total return for the three-year period for the UCRP was 13.26 percent. The funded ratio, on an actuarial basis, was 108 percent. The bond portfolio continues to benefit from a shorter duration than the benchmark. The private equity portfolio had the best overall performance during the periods; this performance, however, does not have a short-term correlation to public markets. The GEP outperformed the benchmark for all periods; the 14 basis points of active return resulted from U.S. equity security selection and an overweight in emerging markets. The portfolio is within guidelines in all asset classes. Interim Treasurer Berggren reported that $1.9 billion had been added in market value during the quarter.

In response to a question from Regent Parsky, Ms. Berggren explained that at present approximately 55 percent of the portfolio is passively invested. The goal is to have 20 percent of the portfolio managed internally. Regent Parsky noted the importance of viewing the returns in relation to the asset allocation plan. A number of Regents have asked

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

why the University's returns are not comparable to those of other educational institutions. The analysis must begin with a comparison with other institutions' asset allocation plans.

Mr. Tom Richards of Richards & Tierney, The Regents' investment consultant, explained that his firm, in consultation with the Treasurer's Office, had performed an asset allocation study of 37 universities with more than $1 billion in assets. The analysis included the institutions' allocations to U.S. equity, international equity, bonds, real estate, commodities, and alternative investments. They found that the minimum allocation to U.S. equity is 9.40 percent and the maximum is 47.40 percent, as compared with the allocation in the GEP of 37.40 percent. He commented that the minimum allocation to alternative investments is 12.01 percent, which is equivalent to that of The Regents' allocation, while the maximum is 67.40 percent.

Regent Wachter recalled that a chart showing investment results for seven large universities had appeared in the *Wall Street Journal*. The results for the University of California were the worst among those institutions. He questioned why UC cannot perform as well as Harvard. The analysis distributed by Mr. Richards illustrates that UC's asset allocation does not conform to that of many institutions due to an overweighting in U.S. equity and bonds.

In response to a question from Regent Pattiz, Regent Wachter explained that "alternative investments" tend to include more non-traditional categories of investments such as hedge funds, private partnerships in real estate, and convertible arbitrage.

Interim Treasurer Berggren pointed out that historically the GEP was managed the same as the UCRP; the asset allocation plan for the GEP is moving to one that is more appropriate for an endowment.

Mr. Martin observed that the present asset allocation plan is certain to produce mediocre results. The Regents must decide whether or not this plan, with lower volatility and lower risk, is appropriate, or whether more strategic investments should be considered. If The Regents' portfolio were invested 50/50 in U.S. and non-U.S. equity, rather than the current ratio, there would have been $1 billion in extra returns in the prior fiscal year. The Regents' portfolio is also comparatively overweighted in fixed income.

Regent Wachter was concerned about the effect a downturn in the stock market would have on The Regents' portfolios. The theory of alternative investments is that they will protect a portfolio during a down market.

Mr. Richards noted that he had distributed a chart showing performance for the 37 comparison universities for the period third-quarter 2001 through third-quarter 2005. The performance of the GEP for FY2005 was 15.58 percent as compared with a minimum of 12.48 percent and a maximum of 24.76 percent. The median performance was 15.25 percent. He emphasized that there had been movement in a positive direction in the asset allocation for the GEP. The asset allocation within the fixed income category in 2005 had an impact on the fund. While The Regents' portfolios have an underweighting in private equity relative to other universities, these investments contributed to the overall performance.

Regent Parsky noted that great progress had been made in the area of asset allocation. It will be important for the future to understand what the staff in the Treasurer's Office is able to accomplish, particularly in the area of Absolute Return.

5. **FIXED INCOME PROGRAM REVIEW**

Managing Director Wedding provided an overview of the assets under management in the fixed income portfolio by fund and by type. He noted that staff in the fixed income group have an average of twenty years of experience in the field. Biographies of these individuals were included with the materials that were mailed to the Committees. The investment philosophy for fixed income states that returns can be enhanced through disciplined active management of risk. In that process, the fixed income group works closely with Managing Director Phillips to ensure that the risk is appropriate. Core sector returns are enhanced by opportunistic investments in non-core securities. Mr. Wedding displayed a chart showing the portfolio construction process, and he stressed the fact that risk management plays a central role. Turning to performance, Mr. Wedding reported that UC's defined contribution bond fund had outperformed the Lehman Aggregate benchmark by an average of 60 basis points over the last five years, which puts UC in the 95th percentile of its peer groups. He displayed information on cumulative out-performance by sector. All core sectors contributed, but the investment in corporate bonds played the most significant role.

Mr. Wedding presented a brief overview of the current macro outlook, which includes the anticipation that the gross domestic product will average 3.75 percent over the next four quarters, which should produce lower unemployment rates. The core Consumer Price Index is expected to rise to 2.5 percent from the current 2.2 percent, while the federal funds rate will be hiked from the current 4.00 percent to 4.75-5.00 percent by late 2006. As a result of these factors, Treasury yields should rise mildly, with ten-year bonds at 5.0 percent by the end of the year. Equity and interest rates should begin a steady increase from the current multi-year lows. Mr. Wedding continued that The Regents' interest rate sensitivity is 3 percent lower than the benchmark. The yield curve should steepen following the current prolonged flattening trend.

Mr. Wedding discussed the process used in the Treasurer's Office to manage credit risk. The credit team's ongoing global approach to evaluating individual credits and industries has successfully led to identifying best investments, regardless of ratings or country venue. The credit team manages more than $6.5 billion of corporate/sovereign risk. Staff in the Treasurer's Office have over 12 years experience in managing Emerging Market (EM) bonds. Current holdings are $550 million; the EM investments have ranged from

$350 million to $1.25 billion. The Office has a significant established network of relationships with EM brokers and dealers, corporate managements, and government officials. A similar approach is taken with respect to high yield bonds; current holdings of $300 million represent eight percent of the UCRP credit sector investments. There have not been any default experiences over the ten years of managing high yield bonds.

Turning to the philosophy of managing corporate bonds, Director Wedding explained that The Regents' portfolio has less credit risk than the benchmark. The downside of that approach is the opportunity cost associated with the loss of yield. The Regents' portfolio outperforms during times of downturn. The credit team has built different platforms for analyzing credit risk: the proprietary UC credit score, the proprietary EFG (Efficiency, Flexibility, and Growth) bond screen, and the Leveraged Buyout screen.

In response to a question from Regent Parsky, Interim Treasurer Berggren stated that the intention would be to move a small amount of the fixed income portfolio, which at present is managed internally, to external managers.

In response to a further question from Regent Parsky, Mr. Wedding recalled that in 1998 the duration of the fixed income portfolio had been 14 years. Over time, the portfolio has been brought more in line with its benchmarks. Regent Parsky observed that this change had generated a significant amount of money for the portfolio. Director Wedding observed that the portfolio could benefit from more specialty fixed income asset classes.

6. **ABSOLUTE RETURN STRATEGIES PROGRAM REVIEW**

Interim Treasurer Berggren explained that Absolute Return strategies are not homogeneous asset classes but rather a collection of diverse investment strategies with similar legal and fee structures, similar due diligence requirements, a lack of position transparency, and limited performance history. The qualities of an Absolute Return program are the following:

- Increases portfolio diversification and lowers overall volatility
- Adds incremental returns to the portfolio without adding more volatility
- Provides excess returns with a low correlation to other asset classes
- Generates positive returns in up or down equity markets
- Allows access to advanced investment management techniques and top investment managers

Ms. Berggren discussed a chart that displayed a ten-year risk/return profile for stocks, bonds, and hedge funds, noting that the hedge funds produced higher returns than bonds and had lower risk and returns than equities. Hedge funds have significantly outperformed the market during S&P down quarters over the last ten years.

Interim Treasurer Berggren recalled that the Committees had on many occasions considered the issue of whether the Absolute Return strategy represents a substitute for fixed income or for equity; in her opinion, it can be either, depending upon the strategy that is employed. It is a substitute for fixed income if low volatility and low leverage strategies are used, while it is a substitute for equity if long-biased, equity-based strategies are emphasized. Absolute Return may also be referred to as an alternative, that is, non-traditional, investment. The volatility resembles that of fixed income. Ms. Berggren displayed a chart showing a ten-year risk/return profile for 11 different hedge fund strategies.

Absolute Return strategies were used initially in the General Endowment Pool to increase the expected return while reducing risk. The first allocation to Absolute Return was a five percent investment in April 2003. The bond allocation was reduced to fund this initial investment. The asset allocation was increased to ten percent of the GEP in August 2005, at which time the allowable strategies were broadened. As with any investment program, there are risks associated with Absolute Return strategies. The largest risk comes from individual manager risk, which could arise from fraud or organizational instability. This risk is mitigated by a thorough due diligence process that occurs prior to investing with any manager. A second risk occurs when there is too much capital chasing the same opportunities, which may result in attractive managers being closed to new investors. It is necessary to find newer strategies where inefficiencies still exist and access is not a constraint. A third risk is decreasing returns from underlying assets, which means lower expected returns for industry. As a result, asset expectations must be adjusted for future returns although the asset class remains attractive. The Treasurer's Office has attempted to address these risks through the investment process. Staff and the Absolute Return consultant, Albourne Partners, screen managers that meet the minimum criteria that have been established with respect to strategy and objectives. The consultant and the staff independently conduct a review and perform due diligence, and the staff submits investment recommendations for review by the Managing Director. Ultimate approval is made by the Treasurer.

Interim Treasurer Berggren then called upon Mr. John Claisse of Albourne Parters for his remarks. Ms. Claisse explained that Albourne, which was founded in 1994 by two former hedge fund managers, is an independent global advisory firm focused solely on hedge funds. The firm has 78 employees with offices throughout the United States, Europe, and Asia, and 60 clients with more than $50 billion invested directly in hedge funds. He stressed that Albourne charges all of its clients a fixed fee for its services.

Mr. Claisse outlined the following services that are offered by Albourne:

- Manager Selection: evaluate underlying hedge funds based on their expected risk-adjusted return.

- Due Diligence: review hedge funds' operations, financial statements, corporate governance, and financial viability on an initial and on-going basis.

- Strategy Timing: evaluate expected and realized risk-adjusted returns for hedge-fund strategies.

- Risk Management: model and monitor fund and portfolio level risks present in a client's portfolio.

- Portfolio Construction: determine optimal strategy and fund level allocations subject to the client's objectives and policy guidelines.

Mr. Claisse emphasized the depth of resources represented by Albourne's structure, which includes staff in the areas of strategy research, due diligence, client service, and IT/administration. He outlined the services that are provided to The Regents. Albourne senior analysts independently evaluate each UC hedge fund investment opportunity. Prior to any investment by The Regents, Albourne conducts a comprehensive due diligence review of the manager's infrastructure, personnel, financial statements, and offering documents. Due diligence reports are updated regularly, and all of the underlying research is provided to the Treasurer's Office. The staff have direct access to all Albourne analysts to discuss specific strategies and the risks associated with the investment. Albourne provides Managing Director Phillips with detailed fund and portfolio-level risk analyses. Mr. Claisse discussed how a portfolio is constructed. Albourne works closely with UC staff to determine an appropriate portfolio target asset allocation designed to achieve The Regents' investment objectives, subject to investment constraints. The portfolio process draws on Albourne's strategy forecasts, due diligence, and risk management tools. Albourne undertakes a quantitative asset allocation review quarterly to monitor UC strategy relative to an optimal portfolio. Albourne and Treasurer's Office staff meet regularly to review manager performance, portfolio performance, and issues that might affect the portfolio.

Investment Officer Choi presented a program overview as of January 1, 2006. There are 12 managers with a market value of $453 million. The portfolio has generated an annualized return of 8.1 percent since its inception, compared with the benchmark* return of 6.2 percent. The allocation to Absolute Return is 8.2 percent of the General Endowment Pool out of an interim target allocation of 10 percent.

*The benchmark was temporarily changed from one-month T-Bill + 4.5% on October 1, 2005.

In response to a question from Regent Parsky, Ms. Choi stated that the change in the benchmark had been recommended by Richards & Tierney. Mr. Richards explained that, after discussions with the Treasurer's Office, it was determined that a two percent premium over T-bills would be an appropriate goal given the type and structure of the strategies and the level of volatility in the market. Mr. Martin saw a need to give the benchmark further consideration.

Ms. Choi explained that, with Absolute Return, the permissible investments include funds that invest primarily in Long/Short strategies, Relative Value strategies, Event Driven strategies, and Opportunistic strategies. The targets and ranges are as follows:

	Target	Range
Long/Short Equity	35%	0-70%
Event Driven	30%	0-70%
Relative Value	30%	0-50%
Opportunistic	5%	0-20%

In response to a question from Mr. Child, Ms. Choi noted that some managers impose liquidity lock-ups. Because the nature of an endowment such as the GEP calls for a long-term strategy, a manager with a lock-up would not be excluded from a manager search. At the end of 2005, about 70 percent of the Absolute Return program was free for redemption.

In response to a further question from Mr. Child, Mr. Claisse commented that Albourne would be prepared to make a recommendation to withdraw from a manager if there were a change in strategy which was outside the manager's experience or if key individuals were to leave the firm.

Mr. Martin asked about future plans for investments in Absolute Return strategies that produce returns similar to equities. Ms. Choi explained that the goal of the Absolute Return program was to achieve a return of 8 to 11 percent over a full investment cycle while keeping volatility low. This would not preclude some strategies that have more volatility than others. Interim Treasurer Berggren continued that the ongoing diversification of the portfolio would involve a number of strategies. There is the potential that a recommendation will be made to The Regents to increase the allocation to 20 percent.

In response to a question from Regent Parsky, Ms. Choi replied that money is invested with one fund-of-funds manager because it is difficult to obtain direct access to the top-tier managers. This investment is generating returns comparable to what would be expected from a direct manager. The real rate of return for calendar year 2005 for the Absolute Return portfolio was 5.9 percent. Mr. Claisse confirmed that this return was in line with the industry.

Regent Parsky believed that it would be appropriate for the Treasurer's Office to make a presentation to The Regents with respect to extending the risk profile; this should be coupled with how the investments would be managed. He supported the consulting arrangement that has been established with Albourne. The issue to consider is whether the University is capable of building a staff that will be able to work with more managers.

In response to a comment from Regent Parsky regarding the ability to withdraw from a manager, Ms. Choi reported that she had redeemed three investments, the first from convertible arbitrage, because investors had become nervous about this manager's strategy.

Committee Chair Lee was concerned that the Absolute Return strategies had returned only 5.9 percent. Ms. Choi explained that the intention was to focus on the preservation of capital. Interim Treasurer Berggren pointed out that it was important to take risk into consideration within the parameters of the portfolio.

Regent Wachter pointed out that the reason that had been given for The Regents' underperformance vis-a-vis other educational institutions had been the underweighting in alternative investments. The return for the S&P 500 in 2005 was 4.9 percent, as compared with the 5.9 percent achieved by Absolute Return. Mr. Wachter stressed that peer institutions such as Harvard University and the University of Texas had found a way to get much better performance from their investments than either the S&P or the University of California. Mr. Martin suggested that was because they are much more aggressive with respect to their hedge-fund strategies. Regent Watchter questioned why, given the excellent performance of the fixed-income portfolio, the Treasurer was attempting to imitate fixed income in the Absolute Return category.

Interim Treasurer Berggren noted that the category "alternative investments" includes sectors that the University has traditionally not invested with, such as commodities, real estate, and timber. She reported that the Office had recently hired a director of real estate assets. The Office understands the need to expand alternative investments beyond venture capital and buy-outs.

Chairman Parsky saw a need to place in context any decision to expand investments in Absolute Return. The question to be addressed is whether it is worthwhile to have this asset category in the portfolio if it is slightly improving the fixed-income returns but not the equity returns. If the only reason for investing in this category is to try to improve the equity returns, it becomes an entirely different program.

Regent Pattiz cautioned against any dramatic restructuring of the asset allocation plan in an effort to improve results.

Consultant Lehmann stressed the fact that the Absolute Return strategy adds diversification to the portfolio.

Regent Wachter noted that the asset allocation plan represents a continuum of investment options that are available to The Regents. It would be a mistake to rule out any option.

7. **INVESTMENT POLICY, GUIDELINE, AND BENCHMARK REVIEW FOR UCRP AND GEP**

The Interim Treasurer and The Regents' Investment Consultant, Richards & Tierney, recommended that the attached Investment Policy Statement (IPS) for the University of California Retirement plan (UCRP) and the General Endowment Pool (GEP) be approved.

Managing Director Phillips recalled that The Regents had adopted Investment Policy Statements for both the UCRP and the GEP, in which specific responsibilities for the various fiduciaries were defined. A conflict of interest policy was also adopted which separated the roles in developing and approving policy versus selecting investment strategies and managers. The Regents' responsibilities center on approving policy, asset allocation, benchmarks, and risk budgets and guidelines, while the Treasurer is responsible for all aspects of implementation, including the development of processes and procedures and the selection of investment products. The Regents determine the amount of risk that is appropriate for each fund, and the Treasurer must ensure that risk is kept within these parameters. The Treasurer is charged with presenting an annual review of policies and guidelines and recommending any changes.

The principal changes in the amended policy statements are as follows. First, the IPS structure has been simplified to facilitate revisions by separating the policy into specific sections for the UCRP and the GEP, with common sections that apply to both plans, which includes their asset allocation, risk budgets, and benchmarks. The main changes are in the derivatives policy and the asset class guidelines. As the Regents recognize the value of diversification, new asset classes have been approved for investment. These asset classes require individual risk budgets and investment parameters. The proposed IPS removes the restriction on the use of options and swaps, subject to the limitations in the derivatives policy. The equity guidelines have been refined to provide additional limits on individual manager risk. Mr. Phillips stressed that the fundamentals of governance remain unchanged.

Mr. Phillips recalled that the Committee had adopted performance benchmarks for each asset class using a set of appropriate criteria, and he provided a list of the benchmarks for the main asset classes. The policy for private equity benchmarks recognizes that there is no good benchmark for evaluating the short-term performance of private equity, and as a result the benchmark for private equity is replaced by the portfolio's actual performance. For Absolute Return, the absence of permanent exposure to capital market risk justifies the use of a cash benchmark. For real estate, it is suggested that the benchmark for non-core private real estate be replaced by the real estate portfolios's actual performance, effective April 1, 2006 for both the UCRP and the GEP. There is no change to the benchmark for core private real estate funds, which will comprise the majority of the real estate allocation at the start of the program.

Chairman Parsky raised the issue of the benchmark for private equity, which is measured by the fund's performance. Mr. Richards commented that the use of a standard benchmark creates distortions with respect to how the fund is performing. A number of different measures are used to evaluate the performance of private equity. Regent Parsky observed that these measures should assist the Regents in understanding how the private equity portfolio is performing. Mr. Richards confirmed that there are expectations with respect to the performance of the portfolio, but there is no single measure that may be used from an accountability standpoint in assessing how the private equity fund is doing. Performance is generally evaluated on a long-term basis.

Managing Director Phillips explained that the guidelines for private equity state that the performance objective is to outperform the U.S. equity market or the Russell 3000 on a risk-adjusted basis over a long period of time. The performance is reviewed every quarter and compared with the Russell 3000 plus 300 basis points and, on that basis, over a ten-year period the private equity portfolio has outperformed by 15 percentage points.

In response to a comment by Regent Wachter, Interim Treasurer Berggren noted that it is important to recognize that there are no market-based benchmarks for this asset class. The movement from 100 percent venture capital to 50 percent buyout and 50 percent venture capital was intended to diversify the portfolio.

Consultant Lehmann agreed that the portfolio should be evaluated on the basis of its strengths and weaknesses because the manager valuations are not useful.

Regent Parsky suggested the need for the Treasurer's Office to give the Regents a mechanism by which the performance may be evaluated. He believed that the recommendation should be approved with the understanding that the private equity benchmark would receive further attention.

Ms. Berggren stressed that the guidelines for private equity were unchanged from those approved by The Regents in 2005.

Upon motion duly made and seconded, the Committee approved the Treasurer's recommendation and voted to present it to the Board, Regents Lee, Parsky, Pattiz, Preuss, Rosenthal, and Wachter (6) voting "aye".[1]

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

The President recommended that the expenditure rate per unit of the General Endowment Pool (GEP) for expenditure in the 2006-07 fiscal year shall be at a rate between 4.75 percent and 4.80 percent of a 60-month moving average of the market value of a unit invested in the

GEP, the exact rate to be determined by the Committee on Finance and The Regents upon the recommendation of the President.

Assistant Vice President Barber recalled that In October 1998, The Regents 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. In the interim years, the payout rate has been increased in stages to 4.65 percent for expenditure in 2005-06. Expressed as a percentage of closing market value of the previous fiscal year, the payout for the 2005-06 expenditure was about 4.2 percent.

Senior Vice President Mullinix reported that the administration intends to recommend to the Committee on Finance a payout rate of 4.75 percent, which is also the recommendation of the Office of the Treasurer. He believed that it would be appropriate to undertake a review of the 60-month moving average over the course of the year.

Regent Parsky moved that the recommendation be amended to reflect the 4.75 percent payout rate. The motion was put to a vote and carried, Regents Lee, Parsky, Pattiz, Preuss, Rosenthal, and Wachter (6) voting "aye."[1]

9. **ADOPTION OF ENDOWMENT ADMINISTRATION COST RECOVERY RANGE**

The President recommended that an endowment administration cost recovery rate of between 25 and 30 basis points (0.25 to 0.30 percent) be approved to apply to the distributions from the General Endowment Pool (GEP) to be made after July 1, 2006, from the eligible assets invested in the GEP to defray, in part, the cost of administering and carrying out the terms of endowments on the campuses and at the systemwide offices. The exact rate would be determined by the Committee on Finance and The Regents, upon the recommendation of the President.

Following an analysis of costs to administer and carry out the terms of endowments on the campuses, The Regents, at the October 1998 meeting, adopted an endowment administration cost recovery rate of 15 basis points (0.15 percent) applied to the eligible General Endowment Pool (GEP) distributions made after July 1, 1998. The recommendation was made pursuant to the March 1998 action of The Regents, in which the endowment administration cost recovery policy was adopted, as permitted by California trust law, to allow the recovery from the endowment payout of reasonable and actual administrative costs for gift assets invested in the GEP. Such costs include compliance with gift terms, reporting, and other related activities necessary to carry out the terms of endowments at the campuses and the Office of the President.

The legal justification for the endowment administration cost recovery policy is a December 1996 opinion from the California Attorney General, in which he stated, "...that Probate Code section 15684 specifically authorizes the reimbursement for all costs properly incurred in the administration of (endowment) funds. All such reimbursements must, however, come from income and not from principal (Probate Code section 16312)." In addition, he said, "...that all such expenses must be properly documented and accounted for and reimbursements subjected to independent audits. To the extent the University has pooled funds and incurs expenses on a pooled basis, it may allocate such expenses among the (endowment) on a proportionate basis."

Since the initial endowment cost recovery study in 1998, further analyses have shown that substantially greater costs were incurred in endowment administration. The actual costs, expressed as a percentage of the 60-month average endowment value, is approximately 50 basis points (0.5 percent). Thus, the proposed rate of between 25 basis points to 30 basis points will recover approximately one-half of the actual costs at the campuses and the systemwide offices.

The funds recovered in this fashion will provide the campuses with an additional source of funds from which endowment administration costs will be paid and will have the effect of releasing the funds currently used to cover endowment administration expenses. The President and the Chancellors have committed to use the funds released by this fund source for incremental fundraising support to enable campuses to enhance their fundraising activities, not as an offset of existing fundraising expenses. The cost recovery program will be reviewed regularly by the Office of the President, as will the impact of the additional funds released for fundraising activities.

Each campus and the Office of the President would be permitted to recover endowment-related expenses up to between 25 basis points and 30 basis points to be taken from the payout. The balance of each year's payout would support the individual endowments' related program activities. Following approval of the related items by the Committee on Finance and The Regents, campuses would be permitted to recover endowment-related administrative costs at the new rate beginning with distributions after June 30, 2006.

Later this calendar year and in early 2007, the Office of the President, in association with the campuses, will study whether it is advisable to recover a greater percentage of the actual costs of endowment administration, perhaps up to the systemwide aggregate average for the costs of endowment administration. Recommendations regarding possible increases in the payout rate and in the endowment administration cost recovery rate will be brought forward in 2007.

Upon motion duly made and seconded, the Committee approved the President's recommendation, Regents Lee, Parsky, Pattiz, Preuss, Rosenthal, and Wachter (6) voting "aye."[1]

(At this point Regent Preuss left the meeting.)

10. **UC ANNUAL ENDOWMENT REPORT AND CAMPUS FOUNDATION ASSET ALLOCATION POLICY**

The Annual Endowment Report for the fiscal year ended June 30, 2005 was submitted for information. The report includes details on all foundation assets, investment and spending policies, and performance comparisons with benchmarks.

Interim Treasurer Berggren recalled that the Investment Policy Statement for the General Endowment Pool includes asset allocation policy and ranges, as well as benchmarks and investment guidelines for the asset classes. It was determined that the campus foundations should adopt the same investment policies as the GEP. Any foundation whose asset allocation policy was not in compliance with the GEP would be asked to request an exception from the Committee. The request should include a summary of the asset allocation process, the rationale for the change, investments policies and differences from the GEP, asset class benchmarks and guidelines, and the oversight processes and controls.

Consultant Behrle asked whether the presentation made at the November 2005 meeting by representatives of the UCLA Foundation had been in keeping with these guidelines. Ms. Berggren noted that the information presented did not include the foundation's investment policies. In addition, the Committee needs to understand why a foundation's benchmarks are different than those for the GEP. The oversight processes were articulated well by the UCLA Foundation.

Consultant Child pointed out that the asset allocation plan for the General Endowment Pool is not in line with those of peer institutions.

Interim Treasurer Berggren recalled that the Committee had requested a quarterly performance report from the foundations. The Treasurer's Office has been working with the State Street Corporation to develop an automated accounting data feed. The first performance measurement will be provided at the May meeting.

11. **REMARKS OF THE CHAIRMAN**

Committee Chair Lee observed that this was his last meeting as the chair of the Committee and as a Regent. He recalled that when he was appointed to the Board by Governor Wilson 12 years ago, the UCRP had a return of 26 percent. When he became chair of the Committee in 1996, the portfolio totaled $32 billion. It has since grown to $50 billion. Regent Lee pointed out that it is the duty of the Regents and the Treasurer to provide an income for retirees. He took the opportunity to express his appreciation to the four Treasurers who had served during his term as a Regent. Regent Lee believed that it had been a mistake to have the Treasurer report to the President as well as The Regents, as politics become involved when there is a dual reporting relationship. His goal as a Regent had been to see the portfolio grow during his tenure. His expressed his appreciation to the staff in the Office of the Treasurer for their role in making this happen. He then passed the gavel to Committee Vice Chair Wachter.

12. **STATUS OF DIVESTMENT FROM SUDAN**

Senior Vice President Mullinix reported that the study group that was authorized by The Regents to make recommendations with respect to divestment from Sudan had held two productive meetings to date. The study group has sent letters to companies that are potential targets for divestment and to investment managers seeking information. The study group has selected the criteria by which to review companies that are doing business in Sudan, and Institutional Shareholder Services (ISS) will be retained to provide additional research. The study group is prepared to present recommendations to The Regents at the March meeting. One issue that has arisen is whether any Sudan policy would also involve the campus foundations.

The Committees went into Closed Session at 4:10 p.m.

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The meeting adjourned at 4:25 p.m.

Attest:

Secretary