The Regents of the University of California

COMMITTEE ON INVESTMENTS/
INVESTMENT ADVISORY COMMITTEE
May 16, 2007

The Committee on Investments and the Investment Advisory Committee met on the above date at UCSF–Mission Bay Community Center, San Francisco.

Members present: Regents Blum, Dynes, Parsky, Pattiz, Schilling, Schreiner, and Wachter; Advisory member Oakley

In attendance: Regent-designate Brewer, Secretary and Chief of Staff Griffiths, Associate Secretary Shaw, General Counsel Robinson, Executive Vice President Darling, and Recording Secretary Smith

The meeting convened at 1:00 p.m. with Committee Chair Wachter presiding.

1. **APPROVAL OF MINUTES OF PREVIOUS MEETING**

Upon motion duly made and seconded, the minutes of the meetings of November 15, 2006 and March 6, 2007 were approved.

2. **QUARTERLY INVESTMENT PERFORMANCE SUMMARY**

Chief Investment Officer Berggren reported that the University of California Retirement Plan (UCRP) and the University of California General Endowment Pool (GEP) had positive absolute and relative performance for the quarter and fiscal year-to-date period. The UCRP returned 2.39 percent for the quarter and 13.35 percent for the fiscal year-to-date, which outperformed the benchmark by 32 basis points and 26 basis points, respectively. The GEP had a return of 2.94 percent for the quarter and 13.8 for the fiscal year-to-date, which outperformed the benchmark by 56 basis points and 94 basis points, respectively. In addition, because April was an excellent month, the overall return to both the UCRP and the GEP is close to 19 percent.

The major contributors to the positive relative and absolute performance for the UCRP were the emerging market equities, core fixed income, and real estate. The US equity portfolio slightly underperformed in the quarter, but it improved in April. A number of strategy changes in personnel have been made. In terms of the overall investing environment, economic growth is good, inflation is low, and corporate profits are good, all of which have a positive impact on performance. Ms. Berggren emphasized that the absolute return for the UCRP and the GEP was positive.

The GEP had a slightly higher absolute and relative return for the quarter in comparison with the UCRP. The largest contributors were emerging market equities, core fixed income, absolute returns, and real estate.

Ms. Berggren pointed out that the portfolio market value was up – close to $1.1 billion for the quarter, and $4.5 billion for the fiscal year-to-date.

3. **APPROVE UCRP/GEP ASSET ALLOCATION RECOMMENDATIONS**

The Chief Investment Officer (CIO) recommended, and Richards & Tierney, Inc. concurred, that the Asset Allocation, Rebalancing Policy, and Benchmarks for the University of California Retirement Plan (UCRP), as shown in Attachment 1, and the University of California General Endowment Pool (GEP), as shown in Attachment 2, be approved, effective July 1, 2007.

Following the adoption of a new Investment Policy Statement for the UCRP in 2004 and GEP in 2005, the Office of the Treasurer has conducted an annual review of asset allocation and investment policy each spring. The purpose of this review is to update the capital market assumptions used in asset allocation, and to recommend any changes to the asset allocation which would better achieve the return and risk objectives of the Funds.

The CIO proposed to continue to increase the allocation to alternatives, but at a measured pace, recognizing the large flows of capital into this area. Realistic targets are proposed for the weights of private equity, real estate, and absolute return strategies over the next 12 months. In addition, long-term asset class target weights are presented for all asset classes.

The principal changes proposed were an expansion of the allocation to absolute return (AR) strategies in the GEP from 15 percent to 20 percent, and an introduction of a small allocation to AR strategies in the UCRP, initially set at 0.5 percent. No changes to asset class benchmarks are proposed.

At the request of the Committee, this proposal modified the existing rebalancing policy as follows. The combined asset group ranges are reduced from ± 15 percent to ± 7 percent above and below combined equity and ± 5 percent above and below combined bonds and alternatives. In addition, ranges are set for individual asset classes. The US Equity weight must be within ± 5 percent of target; all other asset classes must be within ± 3 percent of target. These ranges were chosen to be consistent with Regents' investment policy: the Committee approves asset allocation while the CIO implements policy. The sizes of the bands are based on the size of each asset class (as a percent of the total) and the volatility of each asset class. This proposal is applicable to UCRP and GEP.

The CIO recommended that these changes (asset allocation policy, rebalancing policy, and total fund performance benchmarks) be effective July 1, 2007.

Committee Chair Wachter recalled a commonly expressed notion in the investment business that at least 75 percent of investment returns are determined by asset allocation. He stated that he and Chief Investment Officer Berggren will discuss, and present to the Committee at a future meeting, how asset allocation decisions affect returns.

Ms. Berggren reported that, for the UCRP, the recommendation was to establish an allocation to AR of 50 basis points initially and 5 percent long term. Real estate allocation will be increased to 3 percent short term and 5 percent long term. Private equity allocation will be increased to 3 percent short term and 5 percent long term. These asset classes diversify the portfolio and provide excess overall return to the total portfolio. Caution will be taken regarding choosing managers. In the GEP, the recommendation is to increase allocation of AR from 15 percent to 20 percent. Real estate is increasing to a proposed weight of 5 percent short term and 7.5 percent long term. Private equity is increased to 5 percent short term and 7.5 percent long term. These changes will be funded from the fixed income portfolio.

Regent Parsky inquired about the number of staff working in the real estate and AR areas. Ms. Berggren stated that in the AR area there are a director and two investment officers, who have extensive experience, and a senior analyst and an administrative staff person will be hired soon. She clarified that the real estate asset group does not involve direct purchases, but rather is similar to the private equity and AR portfolio, purchasing limited partnership interests. Townsend Group is the private consultant in the real estate area. Memoranda for the files for each commitment are created, with the concurrence of the consultant. In the AR area, the Office of the Treasurer has a director, an investment officer, and an assistant, and two more staff persons will be hired in that group. Albourne Group, which is considered one of the best consultants in the AR area, is being used. The current staff in AR in the Office of the Treasurer have long experience choosing managers and exercise thorough due diligence.

Regent Parsky expressed his belief that allocation should be increased in the AR area, but he noted that this area has a wide range of strategies that are changing dramatically. He emphasized the need to proceed carefully, particularly given that 20 percent of the GEP will be allocated to this area. Ms. Berggren explained that she has investigated the matter of AR returns strategies thoroughly and has confidence in the capability of the staff. Currently, the Office of the Treasurer has commitments with 20 partnerships, with an eye to increasing the commitments to 30 partnerships. Regent Parsky urged that the Office of the Treasurer continually review this area very carefully, given that there would be heightened public awareness were something to go wrong. He clarified that the funds for the increased allocation will be taken from fixed income, which should drive, in part, the desired risk profile. Ms. Berggren pointed out that the overall volatility of the specific managers in this area is low.

Regent Parsky inquired about the vacancies in staff, particularly in the area of public equity. Ms. Berggren explained that a recruiter has been hired to assist the Office of the Treasurer with hiring a director of public equity. In addition, Ms. Berggren is interviewing selected consultants that will assist in the interim period.

Committee Chair Wachter emphasized the leverage afforded by an increased AR allocation in relation to the risk. He also explained that the Office of the Treasurer has carefully assessed the types of AR funds that are being considered. He has reviewed their assessment found it valuable in that it informed him of the risk and of the overall objective of investing in this area. Committee Chair Wachter recommended that others on the Committee also review this assessment in light of their own concerns.

In response to a question from Chairman Blum, Ms. Berggren explained that the real estate managers fall into several categories, including high–return managers who are involved in opportunistic ventures such as buying warehouses around airports, underdeveloped communities near universities or corporations, and senior housing. An in-depth overview of the real estate investments will be provided at the next, longer meeting of the Committee on Investments and the Investment Advisory Committee. Chairman Blum emphasized the importance of being extremely cautious in the real estate area, given the current risk and reward profile of real estate.

Committee Chair Wachter suggested that the entire alternative and absolute return portfolios be discussed in depth at a future Committee meeting. Regent Parsky stressed the importance of discussing the amount of money that the percentages represent, and the pressure that such amounts create on the Office of the Treasurer staff. Ms. Berggren stressed that staff are very careful when funding the allocations, and are measured by how well they know the managers and how thoroughly they perform due diligence, not by how quickly they reach the allocation. She explained that in the event that the portfolios fall outside the asset allocation range, and the staff believes that such a position is responsible, Ms. Berggren will contact the Committee Chair and discuss the situation.

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

4. **APPROVE CHANGES TO INVESTMENT GUIDELINES**

The Chief Investment Officer (CIO) recommended, and Richards & Tierney, Inc. concurred, that the changes to Investment Policies, Guidelines, and Benchmarks for the University of California Retirement Plan (UCRP) and the University of California General Endowment Pool (GEP) be approved, effective July 1, 2007, as shown in the attachments.

Following the adoption of a new Investment Policy Statement for the UCRP in 2004 and GEP in 2005, the Office of the Treasurer conducts an annual review of investment policy each spring. The purpose of this review is to review investment policies and guidelines in the context of changes in capital markets and investment practices, and where appropriate, recommend any changes to guidelines that would better achieve the return and risk objectives of the Funds.

A. Reduce GEP active risk budget

Currently, the GEP active risk budget is 4.5 percent. This means that the annual standard deviation of the difference in monthly returns between the total fund and the total fund benchmark should be less than or equal to 4.5 percent. The CIO recommended lowering this budget to 3 percent. The current budget was set at this level in 2005, to allow the then Treasurer flexibility in tactical asset allocation. Given the re-balancing proposal, a smaller risk budget is needed.

B. Modify Real Estate Guidelines

The Real Estate Investment Trust (REIT) guidelines have been entirely re-written to be consistent with the US public equity guidelines, as shown in Attachment 3. A risk budget for the entire public Real Estate (RE) program, similar to other public asset classes, is recommended. This overall risk budget would replace the less efficient weight and sector constraints. In addition, a new benchmark is proposed for Non-US REIT strategies: the FTSE EPRA/NAREIT Global ex-US index. The CIO recommends changing the benchmark for US based public real estate strategies, from the Dow Jones Wilshire REIT to the FTSE EPRA/NAREIT US Index. This allocation has not yet been implemented, so no relative performance results will be affected. The CIO believed that this benchmark better meets the risk and return objectives of the program, and permits better performance attribution and program management.

C. Modify Private Equity Guidelines

The CIO recommended that Non-US strategies be permitted in Private Equity, as shown in Attachment 4. Currently the target for Non-US investments is 0 percent (range of 0-10 percent until current emerging market partnerships are closed). A target of 10 percent (range of 0-20 percent) was proposed. This will be funded by reducing the Venture Capital and Buyout strategies by 5 percent each (to 45 percent each). A detailed Non-US private equity strategy will be presented to the Committee at a subsequent meeting.

D. Modify Absolute Return Strategies Guidelines

The CIO, Richards & Tierney, and Albourne Partners recommended certain changes to Investment Guidelines for Absolute Return Strategies, as shown in Attachment 5, with the objective of providing sufficient flexibility to improve returns and risk control, and further diversify the program. The following modifications were recommended:

(1) Establish a guideline based on portfolio downside risk as the preferred metric to limit and manage risk. The aggregate risk of the portfolio will be maintained at a level of 5 percent annual downside deviation or less.

(2) Reduce concentration risk by limiting the allocation to any single manager to 10 percent of Absolute Return portfolio market value.

(3) Modify the portfolio constraint on gross leverage to allow more flexibility in implementation. It is proposed to increase the aggregate (weighted average) gross accounting leverage from 2.5x to 4.5x and to limit to 25 percent of the total portfolio the use of highly levered strategies (defined as average leverage greater than 4.5x).

In response to a question from Regent Parsky, Chief Investment Officer Berggren stated that, with respect to non-US private equity, the plan is to invest in European and Asian established private equity firms, and the Office of the Treasurer staff have experience in both these areas. Regent Parsky reiterated the importance of a separate, detailed presentation on the alternatives area, given the difficulties of hiring.

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

5. **APPROVE FY 2007-2008 ANNUAL INCENTIVE PLAN (AIP) PERFORMANCE OBJECTIVES**

The President and Mercer Investment Consulting recommended that the incentive program asset class investment performance objectives be modified, as indicated in Attachment 6.

As the portfolios evolve in composition and complexity, it is necessary to add or modify some of the performance objectives (target performance over the benchmark) previously established by The Regents. Mercer's investment advisory practice has been involved in the development of this plan since its inception in 2002 and has periodically approved any modifications.

The performance objective for the "UC Entity," the aggregate performance of all assets managed by the Treasurer, will be modified slightly to recognize the change in asset allocation, change in the relative size of the various funds in the entity, and increase in actively managed assets since last year. The process and rationale for this change are consistent with changes in previous plan years, and have been approved by Mercer Investment Consulting.

In accordance with the Plan document, the Treasurer presented a list of eligible participants, and the mix and weighting of performance components for each position, for FY 2007-08.

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

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

The President recommended that the expenditure rate per unit of the General Endowment Pool (GEP) in FY 2007-08 shall remain at 4.75 percent of a 60-month moving average of the market value of a unit invested in the GEP.

The President, in consultation with the Chief Investment Officer, recommended that the expenditure rate per unit of the General Endowment Pool for eligible funds in FY 2006-07 be 4.75 percent of a 60-month moving average of the market value of a unit invested in the GEP. The payout would be distributed in August 2007 for expenditure in FY 2007-08. This would maintain the rate adopted by The Regents in March 2006 for expenditure in FY 2006-07.

At its March 2006 meeting, the Committee on Investments also approved a proposal to maintain the endowment cost recovery rate of 25 basis points (0.25 percent). Endowment cost recovery is taken from the endowment payout each year and is used to recover a portion of the costs of administering and carrying out the terms of the endowments on the campuses and at the systemwide offices. The funds released by this mechanism will be used by the campuses to help support additional fundraising expenses.

In October 1998, following a study, 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 4.75 percent for expenditure in FY 2006-07.

The Treasurer's Office provided 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 FY 2006-07, 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:

A. Maximize long-term total return.

B. Preserve the real (i.e., after inflation) long-term purchasing power of the endowment portfolio's principal and distributions.

C. Optimize annual distributions from the endowment portfolio.

D. Maximize the stability and predictability of distributions.

E. Promote accountability of asset management (disclosures to donors, performance reporting, etc.).

F. Promote the fundraising effort.

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

7. **ADOPTION OF ENDOWMENT ADMINISTRATION COST RECOVERY RATE**

The President recommended that an endowment administration cost recovery rate of 25 basis points (0.25 percent) be approved to apply to the distributions from the General Endowment Pool (GEP) to be made after July 1, 2007, 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.

It was proposed that the endowment administration cost recovery rate be set at 25 basis points (0.25 percent), the same rate approved in 2006. The funds so recovered would help to defray the costs on the campuses and at the systemwide offices of administering and carrying out the terms of the endowments. The funds released by this mechanism would be used by the campuses to increase campus fundraising efforts.

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 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 endowment administration cost recovery rate was increased to 25 basis points (0.25 percent) in 2006.

The legal justification for the endowment administration cost recovery policy is a December 1996 opinion from the California Attorney General, in which he stated, “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, “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 cost to administer endowments, in dollar terms, has been reported by the campuses to be over $36 million, including both Regents’ and Foundations’ endowments. Expressed as a percentage of the 60-month average endowment value, it is approximately 57 basis points (0.57 percent). Thus, the current rate of 25 basis points (0.25 percent) will recover just under one-half of the actual costs at the campuses and the systemwide offices to administer Regents’ endowments.

The funds recovered in this fashion provide the campuses with a source 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 are permitted to recover endowment-related expenses of 25 basis points (0.25 percent) to be taken from the payout. The balance of each year’s payout would support the individual endowments’ related program activities.

The Office of the President, in association with the campuses, will continue to review 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.

Regent Schilling pointed out that the cost of running the funds is in excess of 25 basis points, and inquired as to why the full amount of recovery is not being sought. Executive Vice President Darling explained that because the returns on the endowment have not been sufficient to cover certain funds, such as research funds, funds for faculty who hold endowed chairs, and student scholarships, and because there has not been justification on the cost side, only 25 basis points was being sought. An average has been adopted across all the campuses based on what can be justified. This policy will be reviewed annually and a feasible and appropriate amount charged, with a concern that funds not be diverted from the purpose for which the donor gave the money.

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

8. **AMENDMENT OF REGENTS' INVESTMENT POLICY FOR UC CAMPUS FOUNDATIONS**

This item was withdrawn.

The meeting adjourned at 1:40 p.m.

Attest:

Secretary and Chief of Staff