The Regents of the University of California

COMMITTEE ON INVESTMENTS
INVESTMENT ADVISORY GROUP
September 11, 2007

The Committee on Investments and the Investment Advisory Group met jointly by teleconference on the above date at the following locations: James West Alumni Center, Los Angeles campus; 777 S. California Avenue, Palo Alto; 453 Freedom Parkway NE, Atlanta.

Members present: Representing the Committee on Investments: Regents Brewer, De La Peña, Marcus, Moores, Schilling, and Wachter; Advisory member Croughan
Representing the Investment Advisory Group: Mr. John Hotchkis and Mr. Charles Martin; Consultants Behrle and Hall

In attendance: Secretary and Chief of Staff Griffiths, Associate Secretary Shaw, Chief Investment Officer Berggren, University Counsel Birnbaum, and Recording Secretary Smith

The meeting convened at 1:25 p.m. with Committee Chair Wachter presiding.

1. ABSOLUTE RETURN STRATEGIES MARKET UPDATE

Managing Director Choi reported that the absolute return portfolio returned 17 percent for the fiscal year. The tightening of liquidity in July spread from the subprime markets to all market participants, providing potential buying opportunities in both the credit and equities markets. Ms. Choi assured the Regents that the Office of the Treasurer is exercising discipline regarding these opportunities, reserving available funds until the time is appropriate.

Ms. Berggren pointed out that recent hedge fund declines involved particular managers, with whom the Office of the Treasurer had no involvement, as well as over-leveraged conditions, which has been avoided in the Regents’ portfolios. Ms. Choi discussed that when credit issues surfaced, the Office of the Treasurer immediately contacted its investment managers to assess the University’s situation regarding exposure and liquidity, learning that the Regents’ portfolios had little direct exposure, most of which fell in the financial services sector, and no liquidity issues.

Ms. Choi explained that the Office of the Treasurer monitors the portfolios’ investment leverage on a regular basis across all its managers, aggregating them at the portfolio level to assess total leverage. Currently, measured conservatively, leverage stands at 1.8 times. In addition, the University’s investment guidelines limit leverage to 4.5 times gross accounting leverage, and no more than one
quarter of the portfolio’s capital can be invested with managers who have more than 4.5 times average leverage.

In sum, the Office of the Treasurer was pleased at the performance of the Regents’ portfolios during recent difficult months, much of which was due to proper diversification and manager selection.

Mr. Martin complemented the Office of the Treasurer in its ability to eschew overleveraged asset groups, noting the intelligence of the strategy to avoid low-volatility criteria through the use of fundamentals. Committee Chair Wachter also recognized the ability of the portfolios to remain healthy during recent downturns in the real estate market due to the avoidance of high leverage.

2. REAL ESTATE PROGRAM REVIEW

Managing Director Gil provided an update on the real estate program as requested by the Regents at the Committee’s previous meeting. She explained that investment in real estate enhances the diversification, pays benefits and expenses through the income component, provides competitive risk-adjusted returns, and serves as a hedge against inflation.

Ms. Gil reported that currently the Regents’ portfolios have no exposure to U.S. Real Estate Investment Trusts (REITs) or global real estate securities, which was favorable given recent downturns in those markets. She pointed out that the University’s investment strategies focus on core, enhanced, and high-return strategy attributes. Since the program inception in October 2004, real estate funding in the University of California Retirement Plan (UCRP) and General Endowment Pool (GEP) has totaled approximately $500 million and $200 million respectively; the target is to allocate $3 billion total.

Ms. Gil explained that managers add value to the real estate investment program via several mechanisms, including off-market direct deals, acquisitions at a discount to replacement cost, short-term lease rollovers, lease-buyout potentials, disparities between market and new construction rents, and growth locations with expanding demographic bases. She provided lists of specific funds in which the Regents’ portfolios are invested, and pointed out that the portfolios are diversified across U.S. regions.

In response to a question from Committee Chair Wachter, Ms. Gil explained that core strategy attributes include stabilized, income-producing properties; enhanced strategy attributes include properties with correctable flaws; and high-return strategy attributes include properties that require repositioning, redevelopment, or financial restructuring.

The targets for the real estate strategy as of December 2007 are 40 percent in enhanced strategies, 25 percent in high-risk strategies, 25 percent in core
strategies, and 10 percent in securities. Currently these strategies are co-mingled, but efforts are underway to separate accounts.

Ms. Gil gave an overview of the Office of the Treasurer’s staffing with regard to real estate investment. A goal, set to be completed by March 2008, is to conduct manager searches in the various real estate strategies, using a Request for Proposal process in which managers are selected based on their ability to accept separate account programs and allow flexibility in terms of high involvement by the Office of the Treasurer staff. Managers are interviewed, corporate headquarters are visited, and site inspections on acquired properties are conducted. The Office of the Treasurer also works with a real estate consultant to receive advice on all aspects of the real estate investment program.

Mr. Hotchkis congratulated the team on their high performance relative to the benchmark. Ms. Gil cautioned that such returns are exceptional for real estate and are not likely to be sustainable; normal returns would fall between 8 percent and 15 percent.

Mr. Martin inquired as to how the Office of the Treasurer knows the value of the assets. Ms. Berggren noted that a large amount of time is spent reviewing and reevaluating every asset in the portfolio, and the assets are audited once a year. Ms. Gil explained that valuations are determined by both outside appraisals on an annual basis and in-house appraisals the remaining three quarters, the latter of which usually fall within 10 percent of external appraisers’ estimates. Regent Marcus cautioned that the appraisal process is often flawed; returns are realized only when the assets are sold. He echoed Ms. Gil’s recognition that recent returns are unlikely to continue. Regent Marcus expressed confidence in the manner in which the real estate strategy is being managed by the Office of the Treasurer, noting that there may be opportunities to be more aggressive in the public REIT market.

Ms. Gil emphasized that the Regents’ portfolios have not been affected by the subprime mortgage environment.

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

Upon motion duly made and seconded, the minutes of the meeting of May 16, 2007 were approved.

4. **REAL ASSETS STRATEGY AND RECOMMENDATIONS**

Ms. Gil provided an overview of the real assets strategy. Real assets are hard assets expected to provide valuation protection during inflationary periods. They also provide diversification, act as portfolio insurance, provide higher risk-adjusted returns, have a high income component, and allow participation in the continued industrialization of emerging economies such as India and China.
Investing in real assets also involves significant risks, such as illiquidity, wide dispersion on manager returns, high volatility, and cyclicality.

Currently the fund has exposure to real assets in the form of inflation-linked bonds, real estate, and private equity. The Regents’ portfolios do not have exposure to natural resources such as oil, gas, and timber; infrastructure; farmland; or commodities. Ms. Gil provided a list of possible vehicles for real assets exposure.

Ms. Gil summarized that the proposed recommendation was to create a separate long-term allocation to real assets of 2 percent in the University of California Retirement Plan (UCRP) and 5 percent in the General Endowment Pool (GEP), to be implemented by reducing the U.S. Equity allocation. The overall allocation, totaling $1.3 billion, would be comprised of 25 percent in oil and gas, 20 percent in timber, 25 percent in infrastructure, 20 percent in farmland, and 10 percent in commodities. She noted that an investment officer and analyst will be hired within the Office of the Treasurer to manage the real asset strategy implementation.

Several Regents and Investment Advisory Group members expressed strong reservations about a separate allocation to this class, given the complexity of investing in these assets, especially in advance of hiring dedicated internal personnel with expertise in real assets strategies.

Chief Investment Officer Berggren clarified that the University would participate in these ventures through private limited partnerships in most cases, which will provide the needed expertise, noting that manager selection will be critical to successful investment in real assets. The Office of the Treasurer will also exercise caution regarding specific investment categories. She pointed out that the Regents’ portfolios are underweight in oil and gas and that good managers exist in these areas. Ms. Berggren reiterated that the reason to invest in real assets, from an allocation standpoint, is that they are countercyclical and diversifying. The recommendation was for a long-term, small allocation that would be funded cautiously.

Committee Chair Wachter recalled that some of the real asset strategies discussed are already implemented by specialist managers in the Office of the Treasurer to private equity, real estate, and absolute returns, collectively termed alternative assets. He suggested that rather than approve a separate real assets allocation, the Committee could authorize continued investment in real assets strategies within the existing alternative asset classes. After appropriate specialist investment personnel have been hired and exposure to real assets investments tested, a recommendation for a dedicated allocation to real assets could be brought to the Committee at a later date.
Regent De La Peña asked if the Committee should place a ceiling on the portion of the portfolio to be invested in real assets strategies. Committee Chair Wachter suggested that a maximum of 10 percent of the existing allocation to alternatives be invested in real assets. This would result in a maximum of 3 percent in the GEP and 0.65 percent in the UCRP, emphasizing that the allocation would be part of the existing alternative assets category, not in addition to it. Ms. Berggren agreed with this proposal, and requested that the record state that the Committee gave approval to the Office of the Treasurer to continue to invest in real assets strategies, subject to the limits stated above, and to recruit appropriate personnel.

Faculty Representative Croughan conveyed the faculty’s concern over socially responsible investing, particularly with regard to oil and gas. She hoped that the Committee would take faculty and student concerns into account when considering such investments, perhaps by putting limitations in place.

5. APPROVAL OF REAL ASSETS IN UCRP/GEPA SET ALLOCATION

The Chief Investment Officer recommended, and Richards & Tierney concurred, that the following asset allocation of the University of California Retirement Plan (UCRP) and General Endowment Pool (GEP) be approved. This revised asset allocation would be effective October 1, 2007.

<table>
<thead>
<tr>
<th>All values in percent</th>
<th>UCRP Current Policy</th>
<th>UCRP Proposed Policy</th>
<th>Change from Current Policy</th>
<th>UCRP Long-Term Target</th>
<th>Rebalancing Range (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>US Equity</td>
<td>45.5</td>
<td>45</td>
<td>(0.5)</td>
<td>35</td>
<td>±5</td>
</tr>
<tr>
<td>Intl Dev. Equity</td>
<td>18</td>
<td>18</td>
<td>-</td>
<td>18</td>
<td>±3</td>
</tr>
<tr>
<td>Eqm Mkt Equity</td>
<td>3</td>
<td>3</td>
<td>-</td>
<td>3</td>
<td>±3</td>
</tr>
<tr>
<td>US Fixed Inc.</td>
<td>12</td>
<td>12</td>
<td>-</td>
<td>12</td>
<td>±3</td>
</tr>
<tr>
<td>US High Yield</td>
<td>3</td>
<td>3</td>
<td>-</td>
<td>3</td>
<td>±3</td>
</tr>
<tr>
<td>Intl Fixed Inc.</td>
<td>3</td>
<td>3</td>
<td>-</td>
<td>3</td>
<td>±3</td>
</tr>
<tr>
<td>Eqm Mkt Debt</td>
<td>3</td>
<td>3</td>
<td>-</td>
<td>3</td>
<td>±3</td>
</tr>
<tr>
<td>TIPS</td>
<td>6</td>
<td>6</td>
<td>-</td>
<td>6</td>
<td>±3</td>
</tr>
<tr>
<td>Cash</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>0</td>
<td>±3</td>
</tr>
<tr>
<td>Real Estate</td>
<td>3</td>
<td>3</td>
<td>-</td>
<td>5</td>
<td>±3</td>
</tr>
<tr>
<td>Private Equity</td>
<td>3</td>
<td>3</td>
<td>-</td>
<td>5</td>
<td>±3</td>
</tr>
<tr>
<td>Abs. Ret. Strategies</td>
<td>0.5</td>
<td>0.5</td>
<td>-</td>
<td>5</td>
<td>±3</td>
</tr>
<tr>
<td>Other Real Assets</td>
<td>-</td>
<td>0.5</td>
<td>0.5</td>
<td>2</td>
<td>±3</td>
</tr>
<tr>
<td>Total Equity</td>
<td>66.5</td>
<td>66</td>
<td>-0.5</td>
<td>66</td>
<td>±7</td>
</tr>
<tr>
<td>Total Fixed Income</td>
<td>27</td>
<td>27</td>
<td>0</td>
<td>27</td>
<td>±5</td>
</tr>
<tr>
<td>Total Alternatives</td>
<td>6.5</td>
<td>7</td>
<td>0.5</td>
<td>17</td>
<td>±5</td>
</tr>
</tbody>
</table>

100 100 0 100
6. APPROVAL OF REAL ASSETS INVESTMENT GUIDELINES

The Chief Investment Officer recommended, and Richards & Tierney concurred, that Investment Guidelines for Real Assets investments for the University of California Retirement Plan (UCRP) and General Endowment Pool (GEP) be approved. These revised guidelines would be effective October 1, 2007.

In view of the resolution of the previous two items, this item was tabled.

7. QUARTERLY INVESTMENT PERFORMANCE SUMMARY

Chief Investment Officer Berggren reported that overall performance of both the University of California Retirement Plan (UCRP) and the General Endowment Pool (GEP) had positive absolute and relative performance for all time periods. The UCRP returned 18.83 percent for the fiscal year to date, 11.93 for the three-year period, 11.14 for the five-year period, and 8.40 for the ten-year period, outperforming the benchmarks for each period. She reported that the UCRP was in the first quartile for all pension funds in the country. The GEP had stronger performance, due to a different asset allocation, with gains of 20.01 percent fiscal year to date, 13.92 for the three-year period, 12.32 for the five-year period, and
9.25 for the ten-year period, substantially outperforming the benchmark in every time period.

The principal contributors to performance for the UCRP were the non-U.S. developed, non-U.S. emerging markets, and real estate asset classes. All asset classes, with the exception of U.S. equity and high-yield bonds, had positive relative performance for every time period. The fixed income assets were soft due to the subprime lending environment, fears of inflation, and uncertainty in credit markets. Ms. Berggren observed that the UCRP returns translate to a 7.5 percent actuarial rate.

Factor analysis of the UCRP revealed an underweight in high-yield, large-value, and mid-growth asset classes, and a slight overweight in emerging markets. These categories were also the most significant contributors to risk. In terms of the fixed income portfolio, the average duration was close to benchmark and average quality was slightly better than policy, with AAA ratings comprising 59 percent of the portfolio. Ms. Berggren pointed out that mortgages were underweight by 381 basis points and Canadian bonds were overweight by 104 basis points, contributing 9 and 399 basis points respectively to active return. A review of the active U.S. equity portfolio revealed a reduction in sector exposure. The non-U.S. equity portfolio indicated a small regional underweight relative to the benchmark. The private equity investment performance evaluation showed that the weighted average excess return of the portfolio was 11.4 percent, an exceptional performance with a multiple of 2.1 of costs. Total returns for private equity were 22.48 percent for the UCRP and 23.39 percent for the GEP. Ms. Berggren emphasized that the Regents’ portfolios invested in buy-outs at precisely the right time, as reflected in the excellent three-year performance.

The GEP had very strong absolute and relative performance for all time periods. The largest contributors to performance were non-U.S. equity, private equity, absolute returns, and real estate. GEP characteristics were similar to the UCRP.

Ms. Berggren reported that $586 million was added to the value of the Regents’ portfolios for the quarter, and $6.9 billion in overall market value for the year.

Commenting on the outstanding performance of the portfolio, and in light of recent negative media reports and public comments, Mr. Martin suggested that the University take a more proactive stance in communicating with constituencies regarding the exceptional job performed by Office of the Treasurer staff. Committee Chair Wachter stated that, despite various criticisms, it is hard to argue with exceptional results, which are the result of the overall asset allocation, the relative performance of the portfolios in key asset classes, and the decisions made by the Office of the Treasurer staff within the ranges set by The Regents. Mr. Martin echoed the importance of skilled execution within the asset ranges. Committee Chair Wachter cautioned that such exceptional performance was unlikely to continue; 11.5 percent is not typical in a portfolio of this size,
regardless of asset allocation. He stressed the difficulty of achieving such returns, and that long-term returns are likely to be lower. Ms. Berggren also commended the work of the Office of the Treasurer staff.

In response to a question from Regent Schilling regarding the Short Term Investment Pool (STIP), Ms. Berggren explained that the Office of the Treasurer manages STIP according to preset investment guidelines, and that the funds in STIP are controlled by the campuses. She pointed out that this fund is being investigated at the behest of Chairman Blum in terms of its components and cash requirements, with the eye to improve its investment performance.

8. REVIEW OF PENSION/ENDOWMENT ASSET ALLOCATION PROCESS

Chief Investment Officer Berggren provided a detailed explanation of the process for allocating assets to the University of California Retirement Plan (UCRP) and the General Endowment Pool (GEP). She explained that U.S. equity allocation will be reduced to fund higher allocations in real estate, private equity, and absolute returns. Comparing the GEP with other institutions, allocation is similar, except for an overweight in fixed income and an underweight in real assets and non-U.S. assets. The UCRP is similar to other large plans in equity and fixed income, with a slightly smaller allocation in alternatives, and an underweight in non-U.S. assets.

Ms. Berggren described the steps in the asset allocation process, which include developing capital market assumptions, generating efficient frontiers, evaluating optimal portfolios at different levels of risk, and choosing a portfolio which maximizes expected risk-return tradeoff. This process has been used for all major asset allocation changes since 2000.

Asset class expected returns for the GEP are developed using an equilibrium framework, defined as a long-term time horizon using current market and economic data. The “building block” approach applies bond, equity, and private asset premiums to the Treasury bill rate in order to estimate returns for each asset class. Volatility and correlations are then modified given current conditions, and a range of efficient asset mixes are created to optimize expected returns at different levels of volatility.

Specifically for the UCRP, future outcomes are simulated by computing the funded ratio for each part of the optimal portfolio, with the goal to maximize the funded ratio subject to a downside of less than 10 percent, after which a range of outcomes are simulated at different levels of risk and a level of risk is chosen which results in the best outcome and meets portfolio goals.

The asset allocation process is similar for the GEP to that for the UCRP. Projected annual payments are based on the spending rule and level of assets.
Because less liquidity is needed, there is a greater tolerance for illiquid assets; the GEP has a greater ability to bear risk. The Office of the Treasurer determines the level of investment performance that will satisfy the University’s goal for the endowment. Endowment and spending growth are then modeled under different levels of risk and return, and a portfolio that balances the desire for growth and avoidance of large loss is chosen.

9. **CONFLICT OF INTEREST POLICY AND OVERVIEW OF FIDUCIARY RESPONSIBILITIES FOR NEW COMMITTEE ON INVESTMENT MEMBERS**

This item was withdrawn.

The meeting adjourned at 2:50 p.m.

Attest:

Secretary and Chief of Staff