The Regents of the University of California

**COMMITTEE ON INVESTMENTS**
**INVESTMENT ADVISORY GROUP**
September 10, 2009

The Committee on Investments and the Investment Advisory Group met jointly by teleconference on the above date at the following locations: 1111 Franklin Street, Room 12322, Oakland; 777 S. California Avenue, Palo Alto; J. D. Morgan Center, Los Angeles Campus; and UCSF–Mission Bay Community Center, 1675 Owens Street, San Francisco.

Members present: Representing the Committee on Investments: Regents De La Peña, Kieffer, Makarechian, Marcus, Nunn Gorman, Schilling, and Wachter; Ex officio member Yudof; Advisory members Cheng, DeFreece, and Powell
Representing the Investment Advisory Group: Members Fisher, Martin, and Taylor; Consultants Gilman and Hall

In attendance: Secretary and Chief of Staff Griffiths, Associate Secretary Shaw, General Counsel Robinson, Chief Investment Officer Berggren, Executive Vice President Taylor, Vice President Duckett, and Recording Secretary Johns

The meeting convened at 2:15 p.m. with Committee Chair Wachter presiding.

1. **READING OF NOTICE OF MEETING**

For the record, it was confirmed that notice was given in compliance with the Bylaws and Standing Orders for a special meeting of the Committee on Investments to accommodate a location change and a time change.

2. **PUBLIC COMMENT**

The following persons addressed the Committee:

A. Mr. Nir Hoftman, M.D., an anesthesiology specialist at the UCLA Medical Center, criticized the University for investing in non-U.S. companies that do business with the energy and oil sectors of Iran. He referred to abuses by the Iranian regime and enumerated various divestment measures against Iran enacted or proposed by the U.S. Senate, the California State Assembly, the State Senate, and other bodies. Dr. Hoftman urged the Committee on Investments to take a position on this issue and stated that removal of these companies from the portfolio would not harm investments.

B. Mr. Montgomery Norton, a recent graduate of UC Irvine, thanked the Committee for addressing the proxy voting policy. He noted the financial risk involved in assessment of environmental, social, and governance issues for companies in which UC invests. Mr. Norton cited legislation which might impose fines or sanctions against these companies. The University must carefully manage its proxy voting in this regard to avoid putting its investments at risk.

C. Ms. Alicia Chu, an undergraduate student at UC Irvine, cited UC proxy voting policy, which calls for case-by-case review of environmental, social, and governance issues. She stated that, in voting with management by default, the University was voting in contradiction to its mission and values. Ms. Chu encouraged the University to take an active role in its stakeholder responsibilities.

D. Ms. Pamela Tuttle, a recent graduate of UCLA and a representative of the California Student Sustainability Coalition, cited the University's leadership in sustainability issues and policy. She stated that the University must actively engage in its shareholder responsibilities, which include investing in environmentally and socially responsible companies, consistent with UC's mission and values.

E. Mr. James Grogan, a representative of the UC Union Coalition (UCUC), urged President Yudof to meet with the elected officials of the various labor unions to discuss the budget crisis. He stated the unions' proposal to reduce the pay of the top two percent of UC wage earners and noted that employees earning less than $40,000 are faced with the need to work two jobs and rely on food stamps. To offset the crisis, UCUC recommends short-term borrowing, use of medical center profits, and cuts in wasteful spending. Mr. Grogan cautioned that the future might bring labor strikes and a tarnishing of the University's image.

## 3. APPROVAL OF MINUTES OF PREVIOUS MEETING

Upon motion duly made and seconded, the minutes of the meeting of February 24 and the special meeting of May 7, 2009 were approved, Regents Kieffer, Makarechian, Marcus, Nunn Gorman, Schilling, Wachter, and Yudof (7) voting "aye." [1]

## 4. SECOND QUARTER 2009 AND FISCAL YEAR TO DATE INVESTMENT PERFORMANCE SUMMARY

[Background material was mailed to the Committee in advance of the meeting, and copies are on file in the Office of the Secretary and Chief of Staff.]

Chief Investment Officer Berggren began her presentation by noting that there were enormously divergent trends in fiscal year 2009: a bad market decline in the first nine months followed by an outstanding market rally in the fourth quarter. The UC portfolio reflects overall market performance. The decision to underweight equities by a material amount, as much as ten percent versus policy, benefited the performance during the first

[1] Roll call vote required by Bagley-Keene Open Meeting Act [Government Code §11123(b)(1)(D)] for all meetings held by teleconference.

nine months. The slight underweight in U.S. and non-U.S. equities in the fourth quarter hurt relative performance.

The UC Retirement Plan (UCRP) gained 13.38 percent during the quarter and declined 18.81 percent in the fiscal year to date. The quarterly performance was in the top quartile compared to other pension funds and well above the median for the fiscal year to date. The General Endowment Pool (GEP) increased 10.65 percent during the quarter and declined 17.74 percent in the fiscal year to date, which was very competitive performance compared to most other endowments. The Short Term Investment Pool (STIP) provided positive returns for both the quarter and the fiscal year to date. Total assets increased ten percent during the quarter and declined 14.66 percent in the fiscal year to date.

The overall relative performance of the portfolio was affected by one specific factor. For most of the year, the University had used Treasury bills + 450 basis points as a benchmark for its hedge funds. This benchmark was changed toward the end of the year; however, returns were not restated. If the new benchmark had been used for the entire year, the pro forma variance to the adjusted benchmark would have shown a 72 basis point improvement in the UCRP performance, and 98 basis points for total assets.

A review of the UCRP asset class performance indicates that equity drove performance in the fourth quarter. The equity market posted outstanding gains of 16.99 percent. It was evident during the quarter that the recession was over and that recovery was under way. This overshadowed the decline of Treasury bills, gains in oil prices, and other negative factors. Non-U.S. developed and emerging market equity accounted for better-than-expected earnings and a high risk rally in the quarter. Core fixed income performed well. The performance of the credit portfolio was good, and the government portfolio’s performance was excellent. The high yield bond and emerging market debt portfolios had good absolute performance, but slightly lower relative performance. Ms. Berggren observed that the University has a high-quality portfolio, but that this was a low-quality rally. The most significant detractors from good performance were private equity and real estate. Both of these sectors are affected by the economy and by downward revisions in valuation.

In the UCRP asset allocation, all asset classes were within policy ranges, with the exception of U.S. equity, which was in excess of policy by 200 basis points at the end of the quarter. Treasury Inflation Protected Securities (TIPS) were underweighted. Since June, U.S. equity and fixed income have been moved to be more in line with policy.

Committee Chair Wachter pointed out that, in most discussions of investment returns for pension funds and endowments, performance is defined relative to the benchmark and the performance of the stock market. Given that the market has just experienced the worst financial crisis in 75 years, it would be instructive to examine the University’s actual performance and losses. In fact, the UCRP and GEP performed much better than most pension and endowment funds at public and private institutions. Although the University lost money and the benchmark data may not appear positive, the overall results show that UC lost much less money than most other institutions. The true determinant of returns is asset allocation. The University was well-invested in a number of ways. There was not inordinate exposure in private equity and real estate. The University's portfolio might have performed better if more had been invested in hedge funds. Committee Chair Wachter noted that the University has sometimes been criticized for being too conservative in its investments.

Consultant Gilman emphasized the importance of comparison to peer institutions. The UC investment team outperformed its peer institutions and deserves to be commended.

Ms. Berggren then discussed risk for the UCRP, which was at unprecedented levels. However, the active risk in the portfolio was maintained below the three percent risk budgeted. In factor exposures, there was a negative orientation toward U.S. government securities, collateral or mortgages, TIPS, small value, Japan, and real estate. There was a positive orientation toward credit, mid-value, mid-growth, and non-U.S. bonds. The most significant contributors to risk were an underweight in large growth, an overweight in mid-growth, an underweight in small value, an overweight in small growth, and an underweight in Europe/Asia.

The core fixed income portfolio had a slightly shorter duration than the overall benchmark, 7.3 versus 7.6 years. The average quality was very slightly below the benchmark. More than 70 percent of the portfolio is rated higher than A. The significant underweight in government securities, -9.63 percent, provided 195 basis points of return. The overweight in corporate bonds provided 313 basis points of return. The overweight in mortgages affected the portfolio negatively. Overall, the fixed income portfolio outperformed by 247 basis points during the quarter.

Regent Makarechian asked if the quality ratings were recent and accurate. Ms. Berggren responded that these were current ratings on individual securities. Committee Chair Wachter concurred that they were current. He recalled a meeting with the fixed income team during the worst part of the financial crisis. The fixed income program had relatively few problems compared to the general situation at that time. Investment Advisory Group Member Martin added that the Treasurer's Office does its own due diligence on the credit quality of these instruments; it does not merely rely on the rating agencies.

In response to a question asked by Regent Makarechian, Ms. Berggren noted that, on the credit side, the Treasurer's Office carries out credit analysis on every single security in the portfolio and has a good sense of credit quality. She emphasized that this part of the discussion pertained to the fixed income portfolio.

Chief Financial Officer Taylor pointed out that the core fixed income quality summary showed that the weighted average credit quality was AA, but that about 52 percent of the portfolio was in the A category or below. Committee Chair Wachter confirmed that the weighted average credit quality reflects the market value of the individual securities.

Ms. Berggren then turned to the U.S. public equity portfolios for the UCRP and GEP. Every portfolio characteristic was similar to the benchmark, except that there was a much lower debt-to-equity ratio than in the overall market. In style exposures, the portfolio had more growth and volatility, but smaller size and yield. There were almost no major sector exposures in U.S. public equity. The non-U.S. equity portfolio was similar to the benchmark. In active risk contribution, the largest exposures were sector exposure, country exposure, and currency exposure, at 17 percent, 47 percent, and 13 percent, respectively. In regional exposures, the portfolio was overweight in Developed Europe, underweight in Japan and Canada. In sector exposures, there was an underweight in energy, an overweight in capital equipment, an overweight in services, and an underweight in finance.

The private equity portfolio has a 1.6 multiple of cost. Over the last ten years, the total private equity portfolio has had a 12.78 percent return. The ten-year return for the venture capital part of the portfolio is about 17 percent for the UCRP and about 19 percent for the GEP. The buyout portion of the portfolio is newer and produces an eight percent return.

In response to a question asked by Mr. Martin, Ms. Berggren stated that the Treasurer's Office does not anticipate any major new trends in the fixed income or equity markets. Since the end of the year, the portfolio has been positioned to be fairly neutral on equities and fixed income. Absolute return exposures are being increased because there is more flexibility in the hedge fund absolute return area. She stated that the University should seek returns over the next year in asset classes rather than in asset allocation movement.

Mr. Martin asked about non-U.S. versus U.S. equities. Ms. Berggren responded that U.S. equities are better positioned, but that the University would tend to overweight the non-U.S. emerging markets sector.

Committee Chair Wachter suggested that a portfolio with good hedge fund exposure would perform better before, during, and after the financial crisis. The University's hedge fund exposure has been low in the UCRP, where such exposure is needed. While the University has been slow to invest in hedge funds, the selection has been good. He stated that the University needs to increase this exposure in the future.

Regent De La Peña asked about the Treasurer's Office view of increasing TIPS with possible inflation. Ms. Berggren responded that the portfolio is currently slightly underweight in TIPS. The University has an experienced internal active manager in that area. TIPS are not especially attractive at the moment; the University will move tactically into its policy weight as it sees TIPS becoming more attractive. The Treasurer's Office is concerned about inflation over the next year.

President Yudof asked when data will be available comparing UC's investment performance with that of other major U.S. universities. Ms. Berggren responded that these data are available and have been circulated. Committee Chair Wachter observed that UC performance data are positive, and if STIP figures are included, they are astounding.

President Yudof suggested that these data could be combined with the planned announcement of delayed payment of incentives to Treasurer's Office staff.

Mr. Martin stated that data from leading private universities should be included. Ms. Berggren cited available figures.

Investment Advisory Group Member Fisher advised caution, noting that calling attention to results when they are good creates the risk of visibility when results are negative. He suggested that the announcement about deferred payment should explain that the deferral is not due to investment results, which have been good.

Committee Chair Wachter agreed with Mr. Fisher's position, recalling that the University still lost money. Nevertheless, the numbers are remarkable. The University should publicize its results in an appropriate manner.

## 5. APPROVAL OF PERFORMANCE OBJECTIVES FOR FISCAL YEAR 2009-10 FOR THE TREASURER'S ANNUAL INCENTIVE PLAN (AIP)

The President and Mercer Investment Consulting recommended that the asset class investment performance objectives shown in Attachment 1 be adopted for fiscal year 2009-10.

[Background material was mailed to the Committee in advance of the meeting, and copies are on file in the Office of the Secretary and Chief of Staff.]

Ms. Susan Rowley of Mercer Investment Consulting recalled that the Annual Incentive Plan (AIP) for the Office of the Treasurer was established by the Regents in March 2002. The goal was to attract and retain high-quality staff while encouraging limited risk-taking to provide positive incremental return. Periodic changes are recommended by the Office of the President and Mercer in response to the evolution of the portfolios in composition and complexity. Awards granted by the AIP are based on relative performance – performance versus an appropriate benchmark – not on absolute returns.

Chief Financial Officer Taylor noted that relative performance versus the benchmark is the major driver and the major component that the incentive award is based upon. In fiscal year 2009, fixed income in the UC Retirement Plan (UCRP) and General Endowment Pool (GEP) underperformed the benchmark. He asked if those employees receive no incentive compensation. Ms. Rowley responded that the plan is based on a three-year period and three-year relative performance. Based on a question asked by Mr. Taylor, she confirmed that an award might be received in a scenario of one outstanding year followed by two years of underperformance.

Ms. Rowley then outlined Mercer's recommendations. The absolute return benchmark was changed in March 2009; therefore, the performance standards for the absolute return asset class need to be updated. Treasury Inflation Protected Securities (TIPS) performance standards need to be changed for the new, actively managed portfolio. The entity performance standards need to be recalibrated to reflect changes in relative fund weights and policy targets, allocation of active versus passive management, and changes to underlying asset classes, including absolute return and TIPS.

The absolute return performance objective is a blended benchmark with 50 percent HFRX Absolute Return Index and 50 percent HFRX Market Directional Index, and is stated in the Regents' absolute return investment guidelines. The recommended performance standards are for a threshold at 75 basis points, target at 200 basis points, and maximum at 375 basis points.

In developing these recommendations, Mercer consulted with its absolute return team and with the Regents' absolute return consultant, Albourne Partners Limited. Mercer constructed a custom peer group using hedge fund of funds data from Hedge Fund Research, Inc., and analyzed historical returns of actual funds versus the custom benchmark. There were limited historical data available for analysis. The blended HFRX benchmark has only four years of historical benchmark returns available for comparison versus the custom peer group. Mercer recommends that this analysis be refreshed in a year or two, when more benchmark data become available. There was also significant analysis of underlying funds to create a custom peer group consistent with UC's absolute return investment guidelines.

Mercer attempted to account for a considerable survivorship bias which existed in 2008. Hedge fund assets fell a record $350 billion, or 20 percent, in 2008. A number of funds stopped reporting in 2008 and fell out of the custom peer group, presumably overstating median excess returns of this peer group. In an attempt to account for this, Mercer modeled several different excess return assumptions for funds that stopped reporting returns in 2008. In addition, Mercer analyzed the risk of the current UC portfolio versus the risk of the custom peer group and benchmark. The risk of the UC portfolio versus its peer group was less than the median; on average, it placed in the 36th percentile for risk. This was due to the more conservative investment guidelines for the portfolio, and the Regents' desire to avoid headline risk. The recommended performance standards are consistent with performance standards for other mandates, with an appropriate degree of difficulty based on historical experience of actual managers.

Regent Makarechian asked how targets were determined. Ms. Rowley responded that targets are typically based on median performance in the peer group versus the benchmark. The maximum is at the 75th percentile. This is consistent with the development of performance standards for other asset classes.

Ms. Rowley then discussed TIPS performance standards. The performance objective or benchmark is the Barclays Capital U.S. TIPS Index. The recommended performance standards are: threshold at 5 basis points, target at 12 basis points, and maximum at

24 basis points. Mercer constructed a custom peer group consistent with UC’s TIPS investment guidelines. These performance standards are consistent with performance standards for other mandates, and there is an appropriate degree of difficulty based on historical experience of actual managers.

Mr. Taylor asked who is included in the peer group. Ms. Rowley responded that the group includes other managers, such as PIMCO and BlackRock, other institutional investment managers who manage active TIPS portfolios. In this case the peer group was rather small, with about 20 managers.

Regent Makarechian asked if the target was based on historical experience. Ms. Rowley responded in the affirmative. This target considers three-year rolling time periods over the last ten years, taking into account returns, the risk information ratio, and tracking error.

Ms. Rowley compared current and proposed entity performance standards. The proposed performance standards are: threshold at 4 basis points, target at 32 basis points, and maximum at 70 basis points. The changes from current standards are due to changes over the last year in asset allocation, in the amount managed actively versus passively, in actual asset values in each fund, and in performance objectives for underlying asset classes, including absolute return and TIPS. Real estate is now included in the performance standards as well as the UCRP fixed income, which experienced a change in benchmark. All these factors are reflected and calibrated in the entity performance standards.

In response to a question asked by President Yudof, Ms. Rowley explained that the maximum represented 70 basis points over the asset weighted policy benchmark.

Investment Advisory Group Member Martin stated his view that the entity performance standards do not reward the University’s investment team for making good asset allocation decisions.

Chief Investment Officer Berggren observed that the Regents are responsible for setting overall guidance in asset allocation and for approving asset allocation policy. The Treasurer’s Office implements that policy.

Mr. Martin noted that there are tilts and adjustments made by the Treasurer’s Office which make a significant difference in portfolio performance. These are high-value decisions, but are not rewarded under this system.

Committee Chair Wachter concurred and expressed a willingness to examine proposals by the Treasurer’s Office or Mercer to reward these decisions.

Mr. Martin suggested measuring performance against peer groups, such as all endowments over $1 billion.

Committee Chair Wachter concurred that, within asset allocations, there are many decisions made by the Treasurer's Office staff, not by the Committee. He described these as finer points and remarked that there is no way to measure them. Comparison with peer groups would reveal gross differences, such as significant investments in real estate, or an absence thereof.

Ms. Berggren indicated that all performance is measured relative to policy. The Regents set an asset allocation policy. The decision to underweight or overweight fixed income affects overall performance. If the University had not had a ten percent underweight in equities last year, it would not have experienced the absolute or relative performance it did. Other factors also affect entity performance, such as the performance of equities or absolute return.

Committee Chair Wachter acknowledged that, while the Committee makes many decisions, there are many it does not make.

Investment Advisory Group Member Fisher suggested a model of a bonus pool based on results achieved. Individuals' bonuses are based partly on their individual performance against an appropriate benchmark, and partly on overall performance. The intention is to promote flexibility, not to focus on one asset class.

Ms. Berggren noted that the Treasurer's Office incentive plan works in a similar manner. Twenty-five percent of the incentive is based on entity performance. Unlike other incentive plans, the Treasurer's Office plan also has a subjective portion. The subjective portion of the award is not paid out unless entity performance is satisfactory.

Committee Chair Wachter observed that constant focus on benchmarks is an imperfect system of evaluation.

President Yudof noted that many asset classes have performed poorly in the last few years. He asked about how the incentive system takes account of random variation over years, which could range widely. He described this as a statistical problem. Ms. Berggren responded that the plan uses a three-year average for smoothing.

Committee Chair Wachter reiterated his agreement with Mr. Martin's position about recognition for decisions by the Treasurer's Office staff, but expressed uncertainty about how to address this issue. He suggested that the subjective portion of the award could include such decisions made within asset allocation policy. Ms. Berggren responded that the plan takes this into account for individual asset classes.

Regent Makarechian asked how the proposed objectives compare to existing objectives. Ms. Rowley responded that most of the objectives have not changed. The threshold, target, and maximum objectives for absolute return have increased as a result of the new benchmark, 50 percent HFRX Absolute Return Index and 50 percent HFRX Market Directional Index. The previous benchmark was one-month Treasury notes + 450 basis points. Previously there was no standard for active TIPS because there was not an active TIPS portfolio at the time.

Upon motion duly made and seconded, the Committee approved the President's and Mercer Investment Consulting's recommendation and voted to present it to the Board, Regents De La Peña, Kieffer, Makarechian, Marcus, Nunn Gorman, Wachter, and Yudof (7) voting "aye."

6. **UPDATE ON SEPARATION OF MERCER INVESTMENT CONSULTING'S ROLES WITH RESPECT TO THE OFFICE OF THE TREASURER**

[Background material was mailed to the Committee in advance of the meeting, and copies are on file in the Office of the Secretary and Chief of Staff.]

Chief Investment Officer Berggren stated that Mercer Investment Consulting, the Regents' general investment consultant, also has a role in providing investment expertise with respect to the Treasurer's Annual Incentive Plan (AIP). To mitigate any potential conflict of interest or the appearance of a conflict of interest associated with this, Mercer has agreed to assign the two roles to two distinct Mercer offices, located in Boston and Los Angeles. It has agreed to prohibit any discussion between the two offices on all matters related to the AIP and to remove the investment consultant completely from any decisions related to compensation. Ms. Berggren attested that there have been no prohibited contacts between the two Mercer offices, or between either of them and the Treasurer's Office regarding compensation. The materials provided to the Committee included letters from Mercer on this matter. She emphasized that the Treasurer's Office exercises great care to ensure that these decisions are made separately.

7. **RECOMMENDATION TO CHANGE INVESTMENT GUIDELINES FOR THE SHORT TERM INVESTMENT POOL (STIP)**

The Regents' general investment consultant, with the concurrence of the Chief Investment Officer, recommended that the investment guidelines for the Short Term Investment Pool (STIP) be amended as follows, and as shown in Attachment 2:

The Policy Benchmark, formerly the income return on a constant maturity two-year Treasury note, will now be a weighted average of the income return on a constant maturity two-year Treasury note and the return on U.S. 30 day Treasury Bills. The weights for the two constituents will be the actual average weights of the bond and cash equivalent components of the pool. The Benchmark will be re-balanced monthly. This change will be effective October 1, 2009.

[Background material was mailed to the Committee in advance of the meeting, and copies are on file in the Office of the Secretary and Chief of Staff.]

Mr. Terry Dennison of Mercer Investment Consulting explained that this item concerned a suggested change to the benchmark for the Short Term Investment Pool (STIP).

Previously, the benchmark was based on the income return on a two-year Treasury security; the proposal is to move the benchmark to a weighted average of the income return on a two-year Treasury security and a 30-day Treasury bill, the weights being the actual proportions they represent of the STIP portfolio. The STIP is a cash investment pool available to the entire University for short-term investment needs. The objective of the program is to maximize returns consistent with safety of principal, liquidity, and cash flow requirements. Mr. Dennison observed that there has been a change in the liquidity requirements of the University, in part driven by the financial status of the State of California. This has demanded an increased level of liquidity maintained in the portfolio. It is prudent to increase liquidity in the STIP program, such that the benchmark does not fully reflect the investment environment in which the University now works. Mercer's recommendation, with the concurrence of the Chief Investment Officer, is to amend the investment guidelines, specifically the benchmark, to reflect the fact that there are now two components: a very short-term liquid portion of the portfolio, and a somewhat longer-term portion.

In response to a question asked by Committee Chair Wachter, Mr. Dennison confirmed that the whole portfolio now has a two-year period.

Chief Investment Officer Berggren recalled an earlier proposal to move the entire STIP, or a large portion of the STIP, into an endowment-like portfolio. At that point, there was discussion with the campuses to determine how much of the STIP funds could be invested on a longer-term basis. Over $1 billion was taken out of the STIP and put in the Total Return Investment Pool (TRIP). The TRIP is invested 25 percent in equities and 75 percent in fixed income. This action was taken with downside risk in mind. The TRIP portfolio performed very well last year.

Chief Financial Officer Taylor pointed out that there is a reason for the University's need for excess liquidity in times like the present. In July, August, and September, the University had to send $715 million back to the State. The University was due to receive $750 million in cash this year; this amount has been delayed until June 30, 2010. On May 26, the University anticipated having approximately $1.4 billion more in cash than it now has, due to various State actions. This has compelled the University to secure $1 billion in short-term commercial paper to meet payroll requirements. Considering this action and the University's recent bond deal, which was also intended to increase liquidity, the University will be expending significant amounts of cash in the next two to three months.

Committee Chair Wachter asked about the two-year portion of STIP. Ms. Berggren responded that it is invested in credit and government securities. Mr. Taylor added that the short-term investments are high-grade commercial paper; the kind of investments required by rating agencies.

Committee Chair Wachter observed that, under normal circumstances, two-year high-grade commercial paper is sufficiently liquid. Only recently has it not been so.

Upon motion duly made and seconded, the Committee approved the recommendation of the Regents' general investment consultant and voted to present it to the Board, Regents De La Peña, Kieffer, Makarechian, Marcus, Nunn Gorman, Wachter, and Yudof (7) voting "aye."

8. **RISK MANAGEMENT PROGRAM REVIEW**

[Background material was mailed to the Committee in advance of the meeting, and copies are on file in the Office of the Secretary and Chief of Staff.]

Senior Managing Director Phillips began his presentation by noting recent discussions to the effect that the existing risk management paradigm requires revision. Mr. Phillips acknowledged that this paradigm may need revision, but it is still useful.

Investment risk is the possibility that investments will lose value, will not gain as much value as hoped, or will not gain as much value as the assets of peer institutions. Risk is also an impairment of value that causes investors to make non-economic decisions and take actions they would not otherwise take.

Bearing risk is an essential part of investing. One has to spend money to make money. There are no returns without risk. Risk management is concerned with balancing risk and return expectations. The investment world is uncertain, and investors do not control outcomes, such as whether equities go up or down. However, investors can control how much they invest in equities at a given time based on their opinions about the return on assets. Investors can ensure that they know how much risk they are taking, and whether it is high-quality or low-quality risk. Risk forecasts are not forecasts of losses. Investors do not know when they will lose money. Risk forecasts seek to explain what investors might lose in different situations, based on what they know at a given point.

While the entire Treasurer's Office staff is concerned with knowing the risks the University faces and evaluating potential returns, the risk management program provides a cross-asset class perspective and a total fund perspective on these questions. The risk management process is a series of questions. What level of loss can UC sustain before it must make non-economic decisions? What are UC's risk exposures? What expected returns are necessary to justify those risks? What are the potential losses, given those exposures? What are the catalysts for those losses? Are there protective measures, and how much do they cost?

The formal mission of the risk management program is to determine how much risk is appropriate for UC's various funds, and to develop and implement procedures and processes to help keep risk within those limits. In order to accomplish this, risk management must have some sense of what the risks are and how they will affect the portfolio.

Mr. Phillips outlined risk management roles. The Regents, as fiduciaries, approve asset allocation, benchmarks, and risk budget. The Treasurer's Office staff implements policy, and the risk management program provides quality control to the process, ensuring that risk exposures are appropriate, properly diversified, and adequately rewarded.

Measuring risk as not as simple as computing past volatility of returns. However, knowledge of volatility and the range of past outcomes is useful. Discussion of the "right amount" of risk implies that risk can be measured. Risk is not past loss, but potential future loss. Sometimes the only known factor is the average loss over a period of past years. At other times, there may be a better indication of risk. For example, investors have the potential to lose more when the equity market is at an all-time high than when it is at a ten-year low. Incorporating these signals into the University's risk measures is an important improvement. Volatility is one risk measure and can be useful as a starting point. A risk model is a methodology to measure risk for portfolios based on the current holdings. The University is not interested in its risk over the last ten years if its positions today are completely different. It needs to examine its current positions and make some assessment of their risk.

Factor models are used to identify common sources of return variation among groups of similar securities. Statistical analysis of returns and fundamental security characteristics help to estimate exposures, volatility, and common movement of risk factors. Risk and risk measurement are multidimensional. There is no single number that quantifies risk.

The benefit of common risk measures across all asset classes is that they help evaluate decisions for risk and return. Any investment decision must take into account the risk of the new investment and how it will affect the rest of the portfolio. Common risk measures across the portfolio enable decisions about overweighting one asset class over another, and by how much, and remaining within the risk budget.

Traditional management of risk makes use of constraints and guidelines such as position limits within a portfolio, sector limits, duration limits, and geographical limits. Guidelines are a way for fiduciaries to express their views about risk and their concerns about the portfolio. However, Mr. Phillips emphasized that constraints are in fact proxies for risk, or limits on risk factors. For example, a specific duration limit above the benchmark has less to do with securities than with the risk factor of duration, which may add volatility and return. The Treasurer's Office believes that it is better to work with these factors directly rather than through guidelines and constraints, although it has guidelines and constraints and follows them.

Unlike risk measures or risk factors, guidelines cannot be used in portfolio construction, especially when determining a tradeoff, for example, between overweighting duration and overweighting credit in fixed income; there may be a positive view on both. Risk measures help to make a comparison and examine the expected return per unit of additional risk for one decision versus another.

Mr. Phillips then turned to the current state of risk management. There has been much media attention to the actions of rating agencies which gave AAA ratings to groups of securities made up of sub-prime loans. He stated that this was not the fault of the risk models, but of the assumptions that went into the risk models. After a period of years of low macroeconomic and market volatility, investors took more risk, assuming that this period of low volatility would continue indefinitely. Those assumptions caused those risk models to fail. The University's risk models bear some similarity to models of collateralized debt obligation (CDO) risk used by rating agencies, but are significantly different. While a risk forecast about a particular security based on performance over the preceding few years may be helpful, it is necessary to consider how the present and future may be different from the past. Like portfolio managers, risk managers should be more involved in this area and incorporate some of the same factors into their risk models.

There is an emerging consensus that risk measures should be counter-cyclical. Normally, when returns increase, valuations increase, risk-taking behavior increases, and risk measures decrease. Mr. Phillips posed the question of whether investing is safer or riskier in this environment, when investors are taking more risk and risk measures go down. When this occurred recently, prices and valuations crashed, and investors sought to avoid risk as quickly as possible. Counter-cyclical risk measures would enable a successful strategy, like the one practiced by Investment Advisory Group Member Fisher. Mr. Phillips suggested that the solution would be risk measures which are less dependent purely on price movements. The University should incorporate macroeconomic and valuation signals into its risk measures and focus on avoiding losses rather than just reducing volatility. The Treasurer's Office has begun to focus more on downside risk measures than on pure volatility. A more important question is, with new risk measures, how the University would use its models. It could still misuse its models. Mr. Phillips suggested that the University should use these models to ask questions, not to search for answers that do not exist. A risk forecast is an estimate of what might occur, of potential future losses. If the University can use models to ask intelligent questions and to carry out more stress tests, it will obtain more value from the process. It is important to question one's assumptions continually and to consider the possibility that these assumptions are incorrect.

Mr. Phillips then focused on what the risk management program can and cannot do. It cannot predict the date or extent of market declines, turning points, or trends; its purpose is not to predict losses. Turning to what risk management can do, he reported that the risk management program is bringing a wider perspective to risk measures. This implies that risk is more than just volatility. He reported that one of his main concerns for the next year is the development of strategies for absolute risk in addition to benchmark-relative risk.

Ms. Berggren observed that this point was evident in the discussions about and development of the TRIP. It was determined that campuses are most concerned about financial losses; in response to that concern, the decision was made to develop a portfolio that concentrates on the worst five percent of cases that could occur. The performance of the TRIP portfolio during the last fiscal year was down three percent.

Mr. Phillips noted that the same kind of downside risk process was used in the recent asset liability study carried out with Mercer and presented at the May meeting. This may have been the first time the Treasurer's Office used exclusively downside risk measures as well as a scenario-based approach to capital market assumptions.

The risk management program recognizes the limits of normal distribution and will examine other distributions that are more effective in risk estimates and simulation. Linear correlations are not useful in extreme situations. The program will modify these to develop non-linear measures of co-variation. It will focus more on downside risk. There are explicit tradeoffs involved in becoming more conservative when risk-taking behavior increases. The University might forfeit investment returns by reducing risk exposure when risk measures are low but should be high. Mr. Phillips concluded by stating that he hoped to report progress on all these measures at the time of the next risk management program review.

Investment Advisory Group Member Martin commended Mr. Phillips on his presentation and thoughtful approach.

Committee Chair Wachter asked that Mr. Phillips make this presentation to the full Board. It is a topic of interest to the Regents and relevant to the discussion of the UC Retirement Plan. He suggested that Mr. Phillips discuss in more detail the importance of asset allocation as opposed to benchmarks with regard to UC returns over the last few years. Mr. Phillips could also focus on one of the failures of risk management during the recent market events: the correlation among all asset classes, the mistaken idea that investing in real estate would provide diversification to offset losses in commodities.

Committee Chair Wachter also noted that, at the time the market was collapsing, one could make arguments that it was the time to buy, or not to buy. It is good to examine the new paradigm, but it is most likely that the next 20 years will be more like the period before the market upheaval than the period of upheaval. The University has a continuing need for funds, both for retiree benefits and for its endowment. Concern about risk should not cause the University to miss opportunities for good returns. Finding the proper balance between these concerns could be another focus for Mr. Phillips' presentation.

Mr. Fisher commented that the past may not be predictive of the future. He suggested a focus on event risk, a consideration of types of possible events that might seriously damage the portfolio but are not now being considered at all. This exercise would be beneficial and lead to better decisions.

Mr. Martin emphasized that risk management should be prospective, not retrospective. He pointed out the importance of scenario development and granular examination of activity within asset classes.

Regent Makarechian asked about the risk management team at the Treasurer's Office and about communication among groups in the Office. Ms. Berggren responded there are four team members. Mr. Phillips is the director, and there are three other employees. Mr. Phillips noted that all the groups in the Treasurer's Office communicate with each other regularly about asset allocation and about relevant topics affecting their asset classes.

Mr. Phillips responded to Committee Chair Wachter's earlier comment and concurred that the next 20 years will be different. He emphasized that the risk management program is not discarding procedures; its practices are based on good business sense and the effort to identify risk. This will not change.

9. **REAL ESTATE PROGRAM REVIEW**

[Background material was mailed to the Committee in advance of the meeting, and copies are on file in the Office of the Secretary and Chief of Staff.]

Managing Director Gil recalled that the real estate program was approved by the Regents in October 2004. It currently has 30 advisors, 40 commingled funds, and six separate accounts. The program's allocation of the total UC Retirement Plan (UCRP) is 2.7 percent, with a short-term target of four percent and a long-term target of seven percent. The allocation of the total General Endowment Pool (GEP) is 4.1 percent, with a short-term target of five percent and a long-term target of 7.5 percent.

Ms. Gil discussed a chart displaying institutional real estate performance with peak-to-trough corrections for 1990-94 and 2008 to the present. The 2008-to-present correction shows a dramatic decline in value of 40 percent within four quarters. She noted that she has not seen anything like this in over 25 years in this business.

Turning to debt maturities, Ms. Gil noted that there is about $1.2 trillion in debt that will expire in the next three years. Twenty-one percent, or about $250 billion, is in commercial mortgage-backed securities (CMBS); roughly, for every three dollars in debt from banks and others, there is one dollar in debt from CMBS transactions.

The first three quarters of 2008 were fundamentally strong. But with the sub-prime mortgage crisis and the recession, the last quarter worsened, with falling rents and rising vacancies. The Treasurer's Office predicts further deterioration in 2009, but Ms. Gil emphasized that property markets lag the capital markets by six to nine months. If the recession ends this year, there is hope for some recovery or at least stabilization in 2010.

Job losses have affected office real estate and multi-family housing through declining demand and falling rents. Low import and export volumes have affected industrial real estate, and retail real estate has suffered from declining revenues. Ms. Gil noted some reasons for optimism. There are about four million people around 25 years of age entering the job market every year for the next 10 to 15 years; this should have an impact when the job market recovers.

Debt delinquencies are rising. Margin calls are triggered by declining income and valuations. There is some doubt about the credibility of these valuations. No trades or sales are occurring, yet values are declining tremendously. In one case, the Treasurer's

Office had a portfolio evaluated by two credible appraisers. One appraiser found that the portfolio had declined in value by 15 percent; the other found a 43 percent decline in value. The 15 percent appraisal was represented by the borrower; the 43 percent appraisal was represented by the lender. The University is now in negotiation with the lender, between 15 and 43 percent, to extend the loan. Investors in equities are hesitant to carry out transactions because of the uncertainty in pricing. In this environment, the University can take advantage of stress opportunities.

The real estate investment trust (REIT) market experienced a 70 percent decline. REITs were classified as insolvent, although there was a rally in August with a gain of about 70 percent. The Treasurer’s Office believes this market will be very volatile. There have been capital raises from REIT companies to recapitalize, pay down debt, and buy up distressed properties. Ms. Gil opined that the University should invest in U.S. domestic REITs.

During this period of turmoil, diversification by manager and strategy has helped the University. Its managers are experienced in handling various market cycles. The portfolio is reviewed by a consultant. Approximately 23 percent of the portfolio is medium-high to high risk; about 77 percent is in low to medium risk investments. The University has minimal exposure to single-family housing, land, and debt strategies. Hotel exposures are being monitored. The portfolio leverage is 59 percent, within the maximum guideline of 65 percent. Last quarter the leverage was 50 percent, but because of the decline in valuations, the loan-to-value (LTV) ratio has increased.

The real estate portfolio is still in the build-up stage. The Treasurer’s Office will increase manager diversification and strategy diversification. The portfolio has core, enhanced, and high return funds in both the GEP and UCRP allocations. Leverage will be managed. There is about $1.5 billion in unfunded commitments; $900 million is for commingled funds, and about $400 million is in separate accounts.

Ms. Gil then discussed the portfolio commitments by vintage year and the strategy employed for building the portfolio. At the beginning in 2005, the way to achieve diversification quickly was through an enhanced, open-end strategy. About eight percent of the portfolio, $249 million, was committed and is now fully funded. For 2006, the University committed $555 million or 18 percent of the portfolio; this is now 86 percent funded. At that time, core properties or fully stabilized operating properties were expensive and selling at low cap rates, so the real estate program focused on enhanced and high return strategies. The tactic was to focus on hotel-only, office-only, and senior housing-only strategies. The commitments are only between 1 percent and 1.6 percent of the portfolio. In 2007 there was a larger allocation, almost $1 billion or 31 percent, which is 66 percent funded. This allocation included Asia-only, apartments-only, office, and industrial-specific properties. At the same time, the program issued a request for information for the “build to core” separate account, enhanced, and REIT strategies. The separate account is a good tactical strategy for the University; it can “close the gates” whenever it wishes. The University is not charged fees for these commitments. It will be able to manage diversification and, because of its large allocations, negotiate better fees.

In 2008, the real estate program selected "build to core" managers and allocated $700 million in the separate account program. These managers have been very prudent. Only $200 million has been invested since the 2008 allocation. There is $450 million available for opportunities. The program has been diversified with European and Asian funds, retail-only, focuses on California and New York, and some global funds. 2009 has been the most challenging year for real estate investment staff. The program has only allocated $225 million, or seven percent, of the portfolio. It is 46 percent funded, but without the REIT allocation that was made, it consists of three funds that are 20 percent funded. These are funds with which the program wishes to continue a relationship.

Investment Advisory Group Member Martin asked if the 2.7 percent allocation of the total UCRP is based on commitments. Ms. Gil responded that it is funded. The commitment level is approximately $3 billion, or five percent. She anticipated that this would be invested over a period of three to five years. The program uses a pacing model. Some funds never call the total commitment; the program allows ten percent leeway for some funds.

Regent Makarechian asked if the unfunded amounts are for new acquisitions or partially for previous acquisitions to which the University is already committed. Ms. Gil responded that it is a combination of the two. In the separate accounts, $450 million or $500 million, about half, is for new investments. Of the other half, one-third is used to pay down debt and recapitalize, and two-thirds are for new investments, because the University has not invested in the commitments made in 2007-08.

Regent Makarechian asked about the debt being paid and its relation to declining valuations. Ms. Gil responded that there is a decision-making process in place. Treasurer's Office staff are members of the advisory board for each fund and participate actively. There is always discussion about whether good money should be put over bad deals. Most often, the advisory board will choose not to do so, and the manager must carry out this decision, because the advisory board represents the limited partners in the fund.

Regent Makarechian asked if the unfunded commitments may ultimately not be funded in some cases. Ms. Gil answered in the affirmative, estimating that 15 percent may not be funded. Regent Makarechian asked about the right to do this. Ms. Gil responded that this is not her right; it is the managers who will decide to close the fund. The managers also have an investment period of three years. Regent Makarechian clarified that he was referring to previous deals. Ms. Gil responded that staff have some rights in voting on recapitalization, as advisory board members. Regent Makarechian asked how this decision is made. Ms. Gil responded that the managers provide substantial analysis and valuation of the properties. The staff is experienced not only in investments, but also in operations. Ms. Gil and the staff carry out site inspections, visit properties, and examine submarkets to ensure that claims that are made are accurate. Ms. Gil noted that her background is in operations, property management, acquisitions, and dispositions. At the time when the Blackstone Group was engaged in a large acquisition from Samuel Zell, pricing was increasing by $1 billion in a day. Ms. Gil had concerns about this deal and traveled to New York to learn what was occurring. She found out that 60 percent of the Zell portfolio was originally going to be sold, but because the price increased, the decision was made to sell 70 percent and to keep 30 percent in cities such as Los Angeles, New York, and San Francisco. This eased her concerns. This is an example of the due diligence process that the real estate staff are hired to carry out.

10. **REVIEW OF REGENTS' PROXY VOTING GUIDELINES FOR UNIVERSITY OF CALIFORNIA INVESTMENT PORTFOLIOS**

[Background material was mailed to the Committee in advance of the meeting, and copies are on file in the Office of the Secretary and Chief of Staff.]

Associate Chief Investment Officer Stanton briefly reviewed the Treasurer's Office Guidelines for Proxy Voting which were approved by the Regents in 1994, amended in 2000, and incorporated into the current investment policy statements in 2004 and 2005. Following Employee Retirement Income Security Act (ERISA) guidelines, a responsible fiduciary should consider and focus only on those factors which pertain to the economic value of a plan's investments. The UC proxy voting guidelines are set by the Regents. The guidelines in place since 1994 were revised in November 2000 for three reasons: to resolve potential conflicts of interest; second, in response to the increasing complexity and time-consuming nature of evaluating the number of proxy issues coming to the market at that time; and third, at that time, Russell 3000 and MSCI EAFE Index funds were included in the portfolio, which dramatically increased the number of shares held in the portfolio and the number of proxy votes.

The Treasurer's Office, through State Street Global Advisors (SSgA), makes use of a third party, RiskMetrics Group, formerly Institutional Shareholder Services (ISS), to manage the voting process, including all external actively managed portfolios as well as passively managed portfolios. The service regularly provides a written statement for all proxy votes on all equity assets. The documents used by RiskMetrics in their evaluation are the Treasurer's Office Guidelines for Proxy Voting of October 14, 2004 and SSgA's 2009 Proxy Voting Policy, which is applied to all issues not addressed by the Treasurer's Office Guidelines. SSgA retains RiskMetrics Group to assist with and facilitate the proxy voting process, which includes acting as the actual voting agent processing the proxies, advising as to current and emerging governance issues that SSgA may wish to address, implementing the Treasurer's Office Guidelines and SSgA's Policy with regard to all proxy items, and providing analytical information concerning specific issues and proxy items as well as governance trends and developments. RiskMetrics has developed internal codes for almost every type of voting issue, including environmental, social, and governance (ESG) issues. SSgA has reviewed the codes developed by RiskMetrics. In cases where the Treasurer's Office Guidelines are not specific, SSgA and RiskMetrics guidelines would be used for proxy voting. As proxies are received by RiskMetrics, they are coded, the relevant policies are applied, and shares are voted in accordance with these policies. Proxy items that are newly encountered and have not yet been coded or are not covered by existing policies are passed by RiskMetrics to SSgA's Corporate Governance Group for evaluation. SSgA reviews the issue and develops a position based on its policies and fiduciary obligations. This position is then communicated to RiskMetrics and the shares are voted in accordance with this policy. Each item is voted on in case-by-case fashion.

In developing its positions on any proxy voting issue, SSgA entirely concurs with the position of the U.S. Department of Labor that, when proxy voting decisions may have an effect on the economic value of a plan’s underlying investment, plan fiduciaries should make proxy voting decisions with a view to enhancing the value of the share’s stock.

When considering changes to proxy voting policy, it is important to consider, given fiduciary duties under ERISA, whether the benefit of any particular change outweighs the potential economic benefit or harm to shareholders. SSgA has found no evidence of a significant correlation between social proposals brought by shareholders or activist groups and additional shareholder value. Increased fees would apply if specific, unique guidelines had to be invoked. Mr. Stanton observed that the Regents’ ownership in any one company is not significant enough to control the outcome of a proxy vote. Any changes to the Guidelines for Proxy Voting would require full Board approval. The Regents would have to be sensitive to established policy so that proxy voting would be consistent with the mission of the University.

Former Regent Scorza expressed gratitude to the Treasurer’s Office for its work on this issue. He noted concerns expressed by students about ESG issues in relation to proxy voting. As an example, the University might invest in a company which produces a great deal of greenhouse gas emissions and thus causes regulatory and physical risk, as well as reputational risk, risk of litigation, and risk of being less competitive. Such a company could become a liability for investors. The fiduciaries of the University should consider an ESG strategy. Institutional investors are examining these issues, including climate change, as financial risks. UC should be a leader in this area. The University has policies against discrimination; its proxy voting record should reflect this as well.

Committee Chair Wachter requested a clarification of former Regent Scorza’s suggestion. Former Regent Scorza responded that he advocated guidelines that would allow the third-party proxy voter to vote proxies in accordance with University principles while not affecting returns.

Committee Chair Wachter suggested that, while the main objective of investment is economic, if all things are equal, the University should vote with sensitivity to ESG issues. Former Regent Scorza added that UC should not vote with management by default. He noted that the University’s proxy voters, in one quarter in 2008, voted with management 47 out of 47 times.

Chief Investment Officer Berggren noted that SSgA examined every single proposal and voted in accordance with overall factors that need to be taken into consideration.

Mr. Stanton introduced Andrew Letts, SSgA Vice President of Corporate Governance. Mr. Letts discussed case-by-case voting, observing that most environmental and social proposals are fairly static. In any given year, advocacy groups canvass issues with influential advisory firms. The issues are fairly clear, and the language used in these proposals, such as that for disclosure requests, is standardized. By creating a position with one company, SSgA has addressed this issue wherever it appears. Under ERISA, SSgA must demonstrate a reasonably clear connection between an ESG item it is advocating and shareholder value. Mr. Letts emphasized that SSgA has taken action on this matter and has carried out a study that made use of leading outside rating agencies for ESG factors and examined about 200 factors. SSgA was unable to establish that the market rewards companies who are not polluters. The market has not rewarded companies that score well on ESG factor ratings. A company that is a polluter may perform better than a company that is not. Without a direct correlation between a particular proposal and shareholder value, it is not easy for SSgA to cross the threshold and make determinations that, in SSgA's opinion, would potentially violate ERISA.

There are other practical considerations involved. Many proposals seek disclosure and are put forward on a company-by-company basis. One company may be asked to disclose its greenhouse gas emissions at a level at which its competitors are not required to disclose theirs. As an unintended consequence, that company is then put at a disadvantage in relation to its competitors. SSgA believes that, while this is a shareholder issue, the resolution does not lie with shareholders, but must be sought in regulatory action and at the federal level. A more effective way to address ESG risk might be to address Congress or the Securities and Exchange Commission (SEC). The SEC can apply standardized disclosure requirements for emissions that would apply to all companies. Every individual investor can then make an individual judgment about the relative risk of emissions, comparatively, among all issuers.

SSgA's positions are not fixed; they are examined every year. Mr. Letts recalled that ESG factors are long-term factors. A company like Exxon might not be penalized now, but could be penalized in 15 years. SSgA will continue to examine these factors and their correlation to value. At the present time, SSgA has not found such a correlation.

Former Regent Scorza suggested that the University should act in advance of emerging regulatory risk and reiterated the need for an ESG strategy, including proxy voting guidelines.

Committee Chair Wachter asked if SSgA votes with management in the case of a proposal without any apparent positive or negative economic impact. Mr. Letts responded that, if there were no downside risk to a proposal that achieves social benefits, SSgA would not vote just to achieve that goal. SSgA would vote with management, whether for or against such a proposal.

Committee Chair Wachter identified this as the crux of the issue: the question of whether the University should vote with management in a case where there are no economic implications and some social good would be achieved.

Mr. Letts observed that, when SSgA considers a proposal, it is not important who has put forward that proposal. If SSgA cannot find a reasonable correlation to value, it does not have a good reason to support the proposal.

Mr. Stanton noted that RiskMetrics offers a service, for an additional cost, that examines ESG issues, and, if there is no negative impact on the company, it might vote against management. As a reasonable compromise, this service could be proposed for the Committee's consideration with the proposal to include a cost structure. It would not necessarily have a financial effect on assets or beneficiaries, but would move in the direction of ESG concerns. Committee Chair Wachter concurred with this suggestion.

11. **ANNUAL REPORT ON DIVESTMENT POLICIES – IMPACT OF REGENTS' INVESTMENT POLICIES ON TOBACCO AND SUDAN**

[Background material was mailed to the Committee in advance of the meeting, and copies are on file in the Office of the Secretary and Chief of Staff.]

Chief Investment Officer Berggren reported to the Regents on her assessment of the impact of the Regents' January 2001 and March 2006 decisions, respectively, to exclude investments in companies that manufacture tobacco, and companies with business operations in Sudan. The Committee discussed the information presented, as well as the advisability of reevaluating these policies in the future.

Committee Chair Wachter suggested that the University might consider reexamining this issue in the future.

12. **INVESTMENT CONSULTANT REVIEW OF UNIVERSITY OF CALIFORNIA CAMPUS FOUNDATIONS THIRD QUARTER 2008, FOURTH QUARTER 2008, AND FIRST QUARTER 2009 PERFORMANCE REPORTS**

[Background material was mailed to the Committee in advance of the meeting, and copies are on file in the Office of the Secretary and Chief of Staff.]

The Regents' general investment consultant, Mr. Terry Dennison of Mercer Investment Consulting, referred to Mercer's letters analyzing the results of the performance of the campus foundations and to summaries of the performance itself. Mercer has now completed the reconciliation for three quarters. When Mercer took over this role, it found it necessary to resolve a large number of inconsistencies between performance and benchmarks; and between the foundations, their consultants, and State Street Bank. Mercer has significantly improved control over the reporting of asset allocation and benchmark changes before they occur. The performance of the various campus foundations differs because the asset allocations of those foundations differ. Given the asset allocations, the differences in performance can be explained. Mercer does not have any particular concerns to report to the Committee regarding this item.

The meeting adjourned at 4:35 p.m.

Attest:

Secretary and Chief of Staff

# Proposed Performance Objectives FY 2009-10

## Treasurer's Office Annual Incentive Plan (AIP)

## Performance Objectives for FY 2009-10 (1)

| | | Performance Objectives Relative to Benchmark (1) | | |
|---|---|---|---|---|
| **ENTITY UC TREASURER** | **Benchmark** | **Threshold** | **Target** | **Maximum** |
| **GEP, UCRP, UCRSP[(2)], STIP & TRIP** | Asset Weighted Policy Benchmark | 4 bp | 32 bp | 70 bp |
| **ASSET CLASS:** | | | | |
| **PUBLIC EQUITY** | | | | |
| Combined Equity | Asset Weighted Policy Benchmark (Equity) | 15 bp | 80 bp | 170 bp |
| **PRIVATE EQUITY** | | | | |
| Private Equity - Asset Class | Venture Economics Vintage Year Indices | 50 bp | 100 bp | 200 bp |
| **FIXED INCOME** | | | | |
| Combined Fixed Income | Asset Weighted Policy Benchmark (Fixed Income) | 5 bp | 40 bp | 80 bp |
| **ABSOLUTE RETURN** | | | | |
| Absolute Return | 50% HFRX AR Index + 50% HFRX MD Index | 75 bp | 200 bp | 375 bp |
| **403b ICC FUND** | | | | |
| ICC Fund | US 5-year Treasury Notes Income Return | 5 bp | 30 bp | 60 bp |
| **SECTOR:** | | | | |
| **INCOME FUNDS** | | | | |
| Short Term Investment Pool (STIP) | US 2-year Treasury Notes Income Return | 5 bp | 30 bp | 60 bp |
| Savings Fund | US 2-year Treasury Notes Income Return | 5 bp | 30 bp | 60 bp |
| **FIXED INCOME GOVERNMENT SECTOR** | | | | |
| Treasury Inflation Protected Securities | Barclays Capital US TIPS Index | 5 bp | 12 bp | 24 bp |
| Gov't Sponsored - UCRP | Gov't Sponsored Sector of Barclays Aggregate | 5 bp | 30 bp | 60 bp |
| Gov't Sponsored - GEP | Gov't Sponsored Sector of Barclays Aggregate | 5 bp | 30 bp | 60 bp |
| Gov't Sponsored - 403b Bond Fund | Gov't Sponsored Sector of Barclays Aggregate | 5 bp | 30 bp | 60 bp |
| TRIP Government | Gov't Sponsored Sector of Barclays Aggregate | 5 bp | 30 bp | 60 bp |
| **FIXED INCOME COLLATERAL SECTOR** | | | | |
| Collateral - UCRP | Collateral Sector of Barclays Aggregate | 5 bp | 25 bp | 50 bp |
| Collateral - GEP | Collateral Sector of Barclays Aggregate | 5 bp | 25 bp | 50 bp |
| Collateral - 403b Bond Fund | Collateral Sector of Barclays Aggregate | 5 bp | 25 bp | 50 bp |
| TRIP Collateral | Collateral Sector of Barclays Aggregate | 5 bp | 25 bp | 50 bp |
| **FIXED INCOME CREDIT SECTOR** | | | | |
| Credit - UCRP | Credit Sector of Barclays Aggregate | 5 bp | 30 bp | 60 bp |
| Credit - GEP | Credit Sector of Barclays Aggregate | 5 bp | 30 bp | 60 bp |
| Credit - 403b Bond Fund | Credit Sector of Barclays Aggregate | 5 bp | 30 bp | 60 bp |
| TRIP Credit | Credit Sector of Barclays Aggregate | 5 bp | 30 bp | 60 bp |
| High Yield Bonds - UCRP | ML High Yield Cash Pay Index | 12 bp | 65 bp | 130 bp |
| High Yield Bonds - GEP | ML High Yield Cash Pay Index | 12 bp | 65 bp | 130 bp |
| TRIP High Yield | ML High Yield Cash Pay Index | 12 bp | 65 bp | 130 bp |
| Emerging Market Debt - UCRP | J P Morgan Emg Market Bond Index Plus | 25 bp | 125 bp | 250 bp |
| Emerging Market Debt - GEP | J P Morgan Emg Market Bond Index Plus | 25 bp | 125 bp | 250 bp |
| **REAL ESTATE SECTOR** | | | | |
| Global REITS | 50% FTSE/NAREIT Global ex US Index + 50% FTSE | 25 bp | 125 bp | 250 bp |
| Open End Funds - Core | NFI-ODCE Index | 5 bp | 35 bp | 70 bp |
| Open End Funds - Value Add | NFI-ODCE Index | 25 bp | 100 bp | 200 bp |
| **REFERENCE -- USED IN WEIGHTED PUBLIC EQUITY AND FIXED INCOME CALCULATIONS** | | | | |
| US Equity -UCRP | Russell 3000 Tobacco-Free Index | 15 bp | 75 bp | 150 bp |
| US Equity -GEP | Russell 3000 Tobacco-Free Index | 15 bp | 75 bp | 150 bp |
| Developed Non US Equity - UCRP | MSCI World ex US Net Tobacco Free Index | 18 bp | 100 bp | 200 bp |
| Developed Non US Equity - GEP | MSCI World ex US Net Tobacco Free Index | 18 bp | 100 bp | 200 bp |
| Emerging Markets Equity - UCRP | MSCI Emerging Markets Free Net Index | 25 bp | 125 bp | 250 bp |
| Emerging Markets Equity - GEP | MSCI Emerging Markets Free Net Index | 25 bp | 125 bp | 250 bp |
| Bonds - UCRP | Barclays Aggregate | 5 bp | 30 bp | 60 bp |
| Bonds - GEP | Barclays Aggregate | 5 bp | 30 bp | 60 bp |
| 403(b) Bonds | Barclays Aggregate | 5 bp | 30 bp | 60 bp |

1: Excess performance targets refer to 1, 2, or 3 year investment results as appropriate; all performance objectives are based on total return, net of all management fees
2: UC Retirement Savings Plan = 403(b), 457, and Defined Contribution plan options managed by Treasurer

# UNIVERSITY OF CALIFORNIA

# APPENDICES TO INVESTMENT POLICY STATEMENTS OF UCRP and GEP

Approved May 7, 2009
Replaces version approved February 24, 2009

# UNIVERSITY OF CALIFORNIA
# APPENDICES TO INVESTMENT POLICY STATEMENTS

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**These Appendices are applicable to the UC Retirement Plan (UCRP) and General Endowment Pool (GEP), and are incorporated by reference into the Investment Policies of both UCRP and GEP (hereinafter referred to as "the Fund").** The term "constituents" is used to generically refer to the Pension's participants and beneficiaries, and the Endowment's donors.

**UNIVERSITY OF CALIFORNIA**
**APPENDICES TO INVESTMENT POLICY STATEMENTS**

**APPENDIX 7K**
Last approved: August 16, 2005
This Version: February 14, 2006

## SHORT TERM INVESTMENT POOL (STIP) INVESTMENT GUIDELINES

The purpose for these performance objectives ("Objectives") and management guidelines (Guidelines") is to clearly state the investment approach, define performance objectives and to control risk in the management of the University's Short Term Investment Pool, or STIP ("Program"). These Objectives and Guidelines shall be subject to ongoing review by the Committee. Capital market conditions, changes in the investment industry, new financial instruments, or a change in the Committee's risk tolerance, are among factors to be considered in determining whether the Guidelines shall be revised.

### 1. Investment Policy

a. Background:
The STIP is a cash investment pool established by The Regents and is available to all University groups, including retirement and endowment funds. The STIP allows fund participants to maximize income on their short-term cash balances by taking advantage of the economies of scale of investing in a larger pool and investing in a broader range of maturities.

b. Investment Objective

The Objective of the Program is to maximize returns consistent with safety of principal, liquidity, and cash flow requirements. The primary investment objective is to generate ~~an~~ income from investments in short duration US dollar denominated bonds and cash equivalents. ~~which exceeds the income return on a constant maturity two (2) year Treasury note ("Benchmark")~~. Because the liquidity needs of the University are subject to large and uncertain changes, the fund may materially increase its investments in highly liquid, cash equivalent securities from time to time.

Accordingly, the Benchmark will be a weighted average of the income return on a constant maturity two (2) year Treasury note and the return on US 30 day Treasury Bills. The weights for the two constituents will be the actual average weights of the bond and cash equivalent components of the pool. The Benchmark will be re-balanced monthly.

c. Investment Strategy

The Program shall be implemented by the Treasurer internal fixed income staff ("Manager"). The Treasurer will monitor the Program's adherence to these Guidelines.

d. Performance Objectives

The performance objective of the Program is to meet or exceed the return of the Benchmark, on a consistent basis over time, net of all costs and fees.

e. Risk Objective

The Program shall be managed so that its annualized tracking error budget shall be 75 basis points. ~~Each Manager will have a unique active risk budget, relative to its style benchmark, which is appropriate to its individual strategy, and specified in its guidelines, and which will reflect the risk-return profile of its specific investment objectives.~~

f. Other Constraints and Considerations

- Managers shall comply with applicable State and Federal laws and regulations and the prudence requirement described in section 3(a) of the Policy.
- Manager shall act solely in the interest of the Fund's owners.
- Implementation of this Program shall comply with the Fund's Policy.

## 2. Investment Guidelines

a. Asset Allocation

The portfolio will be invested primarily in marketable, publicly traded, investment grade short term fixed income instruments, notes and debentures denominated in U.S. dollars.

b. Types of Securities

The Program will be invested in a diversified portfolio of fixed income securities, subject to restrictions noted below in section 2c.

The following list is indicative of the investment classes which are appropriate for the Program, given its Benchmark and risk budget. It should not be construed to be an exhaustive list of "allowable" asset types. Security types and/or strategies not specifically enumerated, but which the Treasurer and Regents' Investment Consultant believe are appropriate and consistent with the Investment Policy may also be held, subject to the restrictions in 2c. and 2d. below.

The Program may purchase securities on a when-issued basis or for forward delivery.

1. Fixed income instruments
    a. Obligations issued or guaranteed by the U.S. Federal Government, U.S. Federal Agencies or U.S. government-sponsored corporations and agencies
    b. Obligations of U.S. and foreign corporations such as corporate bonds, notes and debentures, and bank loans
    c. Mortgage-backed and asset-backed securities
    d. Obligations of international agencies, supranational entities, and foreign governments (or their subdivisions or agencies)
    e. Obligations issued or guaranteed by U.S. local, city and state governments and agencies
    f. Private Placements or Rule 144A securities, issued with or without registration rights
2. Short term fixed income instruments (having maturity of less than 13 months)
    a. US Treasury and Agency bills and notes
    b. Certificates of deposit
    c. Bankers acceptances
    d. Commercial paper
    e. Repurchase and reverse repurchase agreements (must be fully collateralized with approved collateral, using approved counterparties only)
    f. Eurodollar CD's, TD's, and commercial paper

g. US and Eurodollar floating rate notes
h. Money market funds managed by the custodian

c. Restrictions

The following security types are **not** permitted:

- Interest rate derivative contracts, including options and futures
- Equity like securities, including but not limited to convertible bonds, preferred stocks, warrants, equity linked notes, and commodities
- Bonds issued in currencies other than US Dollar
- Foreign currency linked notes

The Manager may **not:**

- Purchase securities of tobacco related companies, as per the Policy, section 5b.
- Invest in mutual funds or group trusts unless specifically allowed in its guidelines
- Buy securities on margin
- Sell securities short
- Buy party-in-interest securities
- Buy securities restricted as to sale or transfer, except for 144A securities, which are permitted
- Buy or write structured ("levered") notes
- Employ economic leverage in the portfolio through borrowing or derivatives, or engage in derivative strategies that conflict with the Derivatives Policy
- Purchase or sell foreign exchange contracts

d. Diversification and Concentration

The Program's investments will be appropriately diversified to control overall risk. The following limitations apply in order to manage risk within acceptable ranges:

- **Interest rate risk**
  - No security may have a maturity of more than 5 ½ years
- **Credit risk**
  - No more than 5% of the Program's investments, measured by market value, should be below "investment grade", i.e. rated lower than the following standards or their equivalent by all major NRSRO's
    - Standard & Poor's and Fitch (BBB-)
    - Moody's (Baa3)
  - Commercial Paper must have a rating of at least A-1, P-1, D-1, or F-1
  - The Program's investments should exhibit an average credit quality of A (or equivalent) or better. Split-rated credits are considered to have the higher credit rating as long as the higher rating is given by one of the NRSRO's
  - No more than 5% of the Program's allocation to commercial paper may be invested in any single issuer.
  - Except for securities issued by the US Treasury or Agencies of the US Government, no more than 3% of the Program's market value (exclusive of commercial paper) may be invested in any single issuer.
- **Liquidity risk**

- No more than 10% of the Program's market value may be invested in Private Placements or Rule 144A securities
- The Programs' investments in aggregate of any security may not exceed 20% of that security's outstanding par value, without a written exception approved by the Treasurer.

Subject to the limitations above, the investment manager has complete discretion with regard to choosing sector weights, issuers, and maturities.

e. Managers shall employ best execution. Transactions shall be directed to brokers/dealers designated by the Treasurer at the Manager's discretion when best execution is available.

**3. Evaluation and Review**

a. Policy and Guideline Review

The Treasurer shall review the Objectives and Guidelines at least annually, and report to the Committee on the impact of the Guidelines on the Program's performance.

b. Program performance and risk exposures shall be evaluated at multiple levels in accordance with the Objectives of the Program and individual Managers.

**4. Reporting**

On a quarterly basis, the Treasurer shall provide the following reports to the Committee:
a. A summary of Program investments and risks.
b. A summary of Program performance, on an absolute and benchmark relative basis.

Manager will be required to provide the Treasurer monthly and quarterly reports, including but not limited to:
a. Monthly accounting statements showing portfolio income, holdings and transactions
b. Quarterly review of portfolio and strategy performance including a market outlook
c. Annual statement of compliance with investment guidelines

**5. Definitions: See Appendix 8**