The Regents of the University of California

COMMITTEE ON INVESTMENTS
January 17, 2001

The Committee on Investments met on the above date at UCSF-Laurel Heights, San Francisco.

Members present:	Regents Atkinson, Bagley, Davies, Hopkinson, S. Johnson, Leach, and Miura; Advisory member T. Davis
In attendance:	Regents Bustamante, Connerly, Fong, O. Johnson, Khachigian, Kohn, Kozberg, Lee, Marcus, Montoya, and Preuss, Regents-designate Morrison and Seymour, Faculty Representatives Cowan and Viswanathan, Secretary Trivette, General Counsel Holst, Interim Treasurer Bowman, Assistant Treasurer Stanton, Provost King, Senior Vice Presidents Darling and Mullinix, Vice Presidents Broome, Drake, Gomes, Gurtner, Hershman, and Saragoza, Chancellors Berdahl, Bishop, Carnesale, Dynes, Greenwood, Orbach, and Vanderhoef, and Recording Secretary Nietfeld

The meeting convened at 9:40 a.m. with Committee Chair Hopkinson presiding.

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

Upon motion duly made and seconded, the minutes of the meeting of November 15, 2000 were approved.

2. **REPORT OF THE CHAIR OF THE COMMITTEE**

Committee Chair Hopkinson reviewed the special business which will come before the Committee during the year, as follows:

	Target Date
• New Treasurer in place	Second Quarter
• Initiate incentive compensation plan for the Office of the Treasurer	Third Quarter
• Approve private equity investment strategy and guidelines	First Quarter
• Retain new investment consultant to The Regents	First Quarter
• Formalize equity and fixed income investment strategies	Third Quarter
• Review Foundation investment policies and practices	Second Quarter
• Review separation of endowment and retirement funds and develop an asset allocation plan for	Third Quarter

endowment and Foundation funds which provides for additional investment alternatives	
• Review current asset allocation plan in light of market and liability changes and current plan effectiveness	First Quarter 2002
• Review operating systems and information and reporting needs and finalize Regents' reporting format	Fourth Quarter

Regent Hopkinson noted the intention to bring the incentive compensation plan to the Regents at the May meeting, which would be earlier than indicated as the target date. This plan is key to recruiting for crucial positions in the Treasurer's Office.

In response to a question from Regent Bustamante, Interim Treasurer Bowman explained that the Treasurer's Office will be looking for ways to improve its reporting to include a more in-depth exposition of how returns are generated by investment sector and to give the Regents an opportunity to evaluate the performance of the Office. Performance will continue to be reported quarterly and will be compared with the new benchmarks.

Regent Bustamante asked whether there would be an analysis of the philosophy behind the investment in index funds. Regent Hopkinson responded that such an analysis would be included in the review of the asset allocation plan, which will occur annually.

3. **UPDATE ON ASSET ALLOCATION PLAN IMPLEMENTATION**

Interim Treasurer Bowman recalled that the investment strategy adopted by The Regents on March 16, 2000 required significant changes to The Regents' equity and fixed income portfolios. On May 18, 2000 the Treasurer's Office presented the Regents with a detailed transition plan outlining the steps, time frame, and resources necessary to effect the changes required to bring The Regents' portfolios into compliance with the new asset allocation targets and portfolio guidelines by December 31, 2000.

The main steps in implementing The Regents' new investment strategy involved adjusting the portfolios to the new asset allocation targets, positioning the portfolios to be in compliance with the new policies and guidelines, and funding the required Russell 3000 and Morgan Stanley Europe, Australia, and Far East (MSCI EAFE) index funds. The transition to the new strategies has been implemented, with the portfolios now meeting the new asset allocation targets and portfolio guidelines and with the index funds fully funded. The only exceptions are those previously discussed and approved by The Regents:

- The duration target of June 30, 2001 for the fixed income portfolios, which requires a material duration reduction. The Regents granted this extension in order to take advantage of positive market conditions for long-duration assets.

- The allocations to private equity, which depend largely on deal flow.

- The allocation to international private equity, which will decline to the targeted percentage over time.

Mr. Jeffrey Heil, Head of Equity Investment, provided an update on the transition to the index funds. The Office took advantage of the need to raise $11.5 billion to reposition the stocks in the internally managed portfolios. He reported a smooth transition to the index funds. The stocks that remained in the equity portfolio outperformed both the stocks that were sold and the benchmark.

Mr. Steve Nesbitt of Wilshire Associates discussed the cost of the transition to the index funds. He recalled that at the September meeting he had described the process for transferring $11.5 billion from the internally managed portfolio to the Russell 3000 and the MSCI EAFE index funds during the fourth quarter of 2000. At that time, the cost of the transition was estimated at slightly more than $22 million, including commissions, taxes, and the market impact of trading the securities. Mr. Nesbitt reported that the actual cost was half of the estimate, at $11 million, of which approximately $5 million went to taxes and levies by exchanges and approximately $6 million to the cost of trading the stocks.

Mr. Bowman added that the transition had been well managed by State Street Global Advisors.

4. **PROPOSED REVISION OF PRIVATE EQUITY INVESTMENT APPROVAL PROCEDURES**

The Interim Treasurer recommended that the procedures for the approval of and commitment to private equity investments be revised from those authorized by the Board at its March 20, 2000 meeting to now authorize the Treasurer to invest in private equity provided that:

A. Both the Office of the Treasurer and The Regents' private equity consultant approve the investment.

B. The Regents' private equity consultant's approval or recommendation of the investment is made under a mutually acceptable certification of due diligence.

C. All investments are reported with a summary description to the Investment Advisory Committee and The Regents' Committee on Investments.

Interim Treasurer Bowman recalled that the new asset allocation plan required that any private equity investment proposed to be made by the Office of the Treasurer be approved by the private equity consultant and the Treasurer and then be submitted to and approved by both the Investment

Advisory Committee and the Committee on Investments. This procedure does not allow for timely investment decisions. The recommended change will enable private equity investments to be made only with the recommendation and/or approval of both the private equity consultant and the Treasurer's Office in accordance with specified procedures.

Mr. Bowman described these procedures as depicted on a flow chart which had been provided to the Regents in advance of the meeting. Investment proposals will be reviewed by Cambridge Associates and the Office of the Treasurer, with the opportunity to accept or reject any investment proposal based on the initial review. If the proposal is accepted, it is subjected to a policy and strategy review using guidelines developed by Cambridge with respect to issues such as the size of the investment and desirable investment sectors. If the policy guidelines are met, both the consultant and the Office of the Treasurer will perform due diligence to ensure that the investment has the opportunity to succeed. If the investment decision is positive, the transaction will be executed by the Office of the Treasurer and reported to the Committee on Investments and the Investment Advisory Committee.

Interim Treasurer Bowman referred to a second document which had been distributed to the Regents which illustrated the form to be used by the private equity consultant when making a formal recommendation for an investment in a fund. The form includes the endorsement by Cambridge Associates of the proposed investment.

Regent Hopkinson observed that the recommended procedures were consistent with the Treasurer's authority but also involve the services of an outside consultant. The Treasurer would not be provided with any additional authority as individual investment decisions currently are not presented to The Regents for approval. Regent Hopkinson stressed that the program would not be undertaken until the Board of Regents has approved the investment guidelines and the Office of the Treasurer has hired people to staff the private equity area. She noted that the proposed certification statement to be signed by the private equity consultant when a recommendation for an investment is made should be addressed to The Regents rather than to the Office of the Treasurer. This procedure will maintain the consultant's independence.

Regent Connerly raised the issue of a private consultant having the power to reject an investment proposal made by the Treasurer. General Counsel Holst noted that the Committee on Investments would have the authority to revisit any such proposal.

In response to a question from Regent Marcus, Interim Treasurer Bowman recalled that the Wilshire asset allocation study provides broad guidelines for the private equity area. The Office of the Treasurer has also used internal guidelines to review investments in venture capital. The new plan anticipates that investments will be made outside of venture capital in areas such as corporate restructuring and leveraged buy-outs. New guidelines will be developed for these areas of investment by the private equity consultant.

In response to a question from Regent Bustamante, Mr. Bowman explained that Cambridge Associates would serve at the pleasure of the Board of Regents. The contract will provide for 30 days' notice of termination. Regent Hopkinson added that the consultant will provide an additional level of experience. The day-to-day activities will continue to take place within the Office of the Treasurer.

Mr. Nesbitt commented that it is difficult to reverse an investment in private equity because these investments are of a long duration with money locked up in the partnerships. Most fiduciaries desire an extra level of due diligence for this investment category.

5. **ADOPTION OF POLICY TO EXCLUDE SECURITIES OF COMPANIES MANUFACTURING TOBACCO PRODUCTS FROM INDEX FUNDS AND TO CONTINUE EXISTING EXCLUSION FROM ACTIVELY MANAGED FUNDS**

The President recommended that:

This action be taken in recognition of the convergence of a number of factors, specifically, the negative financial risk and liability circumstances affecting the stocks of tobacco products companies, the related health issues, the small percentage such stocks represent of total index funds, the current practice of the Treasurer of excluding investment in the stocks of tobacco products companies for the actively invested funds, and the availability of established tobacco-free index funds, all such factors being specific to this set of facts.

A. The Treasurer, using the standards established for the Russell 3000 Tobacco Free Index and the MSCI EAFE Tobacco Free Index, shall continue the current practice of not directly investing in tobacco products companies.

B. The Russell 3000 Tobacco Free Index and the MSCI EAFE Tobacco Free Index, which exclude the stocks of tobacco products companies, be adopted as the index funds authorized by the Asset Allocation Plan.

C. Should the Treasurer determine at any time that The Regents' investment objectives are compromised by this policy, a report describing the circumstances shall be prepared by the Treasurer with appropriate recommendations.

It was recalled that the asset allocation plan called for the transfer of a portion of the equity holdings to funds intended to track the Russell 3000 index for U.S. equities and the MSCI EAFE index for non-U.S. equities.

The funds under the purview of the Treasurer's Office have no investments in tobacco products companies. Due to the health issues associated with tobacco and the complex legal issues that result, the securities of such companies possess unique and non-quantifiable elements of financial risk, independent of normal economic considerations, that render investment in these securities, either independently or in an index fund, undesirable. In particular, litigation based on the acknowledged adverse health effects of tobacco use poses large and unpredictable liability risks.

The Treasurer's Office excludes investments in tobacco stocks for all actively managed funds, and this practice shall be continued. Unless the policy to invest in two new index funds is modified, investments in tobacco products companies would result. The best interests of The Regents require that the practice which has resulted in no investments in such companies in the actively invested portfolios be extended to the index funds. Alternative investments will meet The Regents' investment objectives without exposing the portfolios to the risk associated with such companies. As tobacco stocks currently constitute only .57 percent and .47 percent of the original indices, their exclusion should have no material effect upon potential investment returns or diversification.

The exclusion of tobacco product companies necessitates the selection of new indices for accurate comparison of performance. Tobacco-free indices maintained by the Frank Russell Co. and Morgan Stanley Capital International adhere to the same standards as the Russell 3000 and the MSCI EAFE indices, respectively, with the exception that they exclude tobacco products companies as defined in accordance with the criteria below. The cost to substitute these two new indices is approximately $20,000.

The Frank Russell Co. and Morgan Stanley Capital International construct their tobacco- free indices by excluding stocks classified as being tobacco stocks. They define a tobacco stock as the common stock of a company which derives its revenues from the manufacture and distribution of tobacco products or, if in a diversified company, that no other business line contributes more revenues or earnings than tobacco products. This currently results in the exclusion of seven companies from the Russell 3000 Index and seven companies from the MSCI EAFE index.

Secretary Trivette distributed communications received concerning the proposed policy.

(For speakers' comments, see the minutes of the January 17, 2001 meeting of the Committee of the Whole.)

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

6. **REQUEST FOR PROPOSALS FOR CONSULTING SERVICES TO CONDUCT REVIEW OF INVESTMENT PROGRAM**

Committee Chair Hopkinson reported that the University is preparing to issue a Request for Proposals (RFP) to obtain general consultant services in connection with the ongoing review of the investment program. The first phase of the work has been performed by Wilshire Associates. The consultant services will be conducted for a term of three years, at a fee to be negotiated with the successful consulting firm.

The investment funds managed by the Office of the Treasurer consist of the University's retirement, defined contribution, and endowment funds, as well as the system's cash assets. As of November 30, 2000, the Treasurer's Office managed $57 billion in total assets.

At the May 2000 meeting, The Regents approved a recommendation to execute an amendment to an agreement with Wilshire Associates for general consultant services in connection with implementation of the asset allocation plan, for a term of one year at a fee of $350,000. The University's contract with Wilshire Associates expires on March 31, 2001. The asset allocation plan calls for the continued retention of a general consultant, reporting to the Committee on Investments and The Regents, to provide ongoing advice on asset allocation, investment policy, manager selection or termination, performance measurement, and reporting. The general consultant would also assist in implementing the recommendations in the asset allocation plan.

Senior Vice President Mullinix reported that, as a result of comments received, several corrections were necessary to the informational item which had been distributed to the Regents in advance of the meeting. The corrections are indicated below by underscoring.
The general consultant would be responsible for the following scope of services:

- Perform periodic (at least annual) evaluations of The Regents' asset allocation plan, giving consideration to market conditions, the financial condition of the individual funds under management, risk tolerance, and other relevant considerations, such as cash flow requirements <u>and overall plan liabilities</u>. Include a review of the objective for each asset class currently in the plan as well as others that may be considered.

- Examine the appropriateness of the investment benchmarks to assess investment performance. Review investment performance against appropriate benchmarks, including the investment performance for each asset class.

- Provide on a quarterly basis, in a form acceptable to The Regents, an evaluation of the performance of the funds managed by the Treasurer. These reports shall consist of an executive summary and a detailed analytical review of the investment portfolios.

- Provide assistance and recommendations in the periodic review and development of investment policies, procedures, and investment guidelines to document and enhance the management of funds. Evaluate investment performance objectives and limits on investment risk for the stock and bond portfolios.

- Evaluate the performance of the index fund managers and recommend changes as needed.

- Evaluate performance of the private equity consultant and function on an annual basis and report the findings to The Regents, in an acceptable form.

- Perform specialized studies and produce needed reports on specific investment matters, as may be requested.

- Report on campus foundation investment <u>policies and</u> performance as may be requested.

- Performance of the required functions will, at a minimum, necessitate attendance and presentations at four Investment Advisory Committee meetings and six Regents meetings each year. In addition, attendance at various committee meetings reviewing retirement plan issues and foundation directors' and board meetings will be necessary.

Qualifications of the Consultant

The objective of the review is to ensure that the University investment programs meet or surpass prevailing industry standards. Accordingly, the consultant selected must demonstrate considerable knowledge of investment management programs and organizational structure, market performance, and asset allocation strategies. The consultant should also have extensive experience in reviewing programs at organizations of comparable size and complexity.

Content of Proposals

Firms will be asked to provide the following information in their proposals:

- An executive summary highlighting why the firm believes it is best qualified to conduct the University's investment program review.

- A work plan for the services to be provided.

- A description of the firm's experience in conducting investment program reviews for private and public entities, including highlights of experience with investment programs for retirement plan portfolios and endowment portfolios.

- A description of the firm's resources.

- A list of current clients, both private and public entities, including information on relative size of portfolios, type of engagement, and client retention rates.

- Resumes (including experience, years and type of experience, and number of years with the firm) of the personnel whom the firm has tentatively identified as the staff working on the engagement. The University will require specific designation of the key responsible person on the engagement.

- Six references, including at least three present clients and at least three clients for whom services have been provided for at least three years.

- A description of the firm's policy on changing staff assigned to a project. The University will require its prior approval before any additional or changed staff are moved to the engagement.

- If the firm is the subject of any litigation or professional disciplinary action that might adversely affect its ability to carry out a multi-year audit engagement, a description of the litigation or disciplinary action.

- A description of any situation which could potentially present a conflict of interest for the firm in performing the services.

- Cost of the services as outlined below.

The firm's proposal should include appropriate business terms and conditions. The University will reserve the right to negotiate the contract terms, conditions, and requirements contained in the proposals.

Responders to the RFP will be asked to include all professional fees (hourly or flat rate) and other expenses required to perform the specified services. As part of the proposal, an estimate of person hours needed to conduct the review, including preparation of the report and ancillary costs, will be requested. The agreement will be awarded based on the best value proposal, not strictly on the lowest cost proposal. The proposal is to include a maximum guaranteed cost.

Other requirements specific to this RFP were provided in the informational item which had been distributed to the Regents.

The consultant services will be conducted for a term of three years, at a fee to be negotiated with the successful consulting firm. The proposal will indicate how fees would be determined for ensuing years. The fee schedule will be expanded to include the total not-to- exceed fees, including out-of-pocket expenses, for the basic engagement work for the years ending March 31, 2002, 2003, and 2004. The contract will contain a provision for termination of the contract by The Regents without cause with a 30-day notification.

The consultant will be selected based upon knowledge, experience, professional reputation, value, and responsiveness to this Request for Proposal. The University may conduct an oral interview prior to selection of the final candidate. Proposals must be submitted no later than February 12, 2001. An appointment recommendation will be made to The Regents at the March meeting.

Regent S. Johnson asked about the consultant's responsibility with respect to the performance of the campus foundations. Regent Hopkinson explained that this request evolved from discussions held between foundation representatives and the Investment Advisory Committee in recognition of the important responsibility of The Regents with respect to the foundations. Interim Treasurer Bowman added that the consultant would provide the Office of the Treasurer with ideas on how best to provide needed services to the foundations.

Regent Miura asked whether the review of the foundations was to be at the request of the foundations or The Regents. Regent Hopkinson affirmed that it would be at The Regents' request as a result of the Board's fiduciary responsibilities for the funds invested by the foundations. (For speaker's comments, see the minutes of the January 17, 2001 meeting of the Committee of the Whole.)

7. **ANNUAL ENDOWMENT INVESTMENT REPORT**

Interim Treasurer Bowman presented the **Annual Endowment Investment Report** for the Fiscal Year ended June 30, 2000. This report provides the Committee on Investments with information on The Regents' General Endowment Pool as well as the asset allocation and returns for each of the campus foundations. He noted that the assets of some of the foundations are managed entirely by the Office of the Treasurer and some by outside managers, while other foundations use a combination of programs. The Treasurer's Office is in the process of enhancing its working relationship with the foundations.

[The report was mailed to all Regents in advance of the meeting, and a copy is on file in the Office of the Secretary.]

Regent Lee drew attention to the relatively poor performance of the UCLA Foundation. Mr. Bowman observed that performance tended to fluctuate over time. Mr. Nesbitt continued that performance must be evaluated in the context of what each foundation is seeking to accomplish.

Regent Hopkinson noted that the foundations welcome increased interaction with the Office of the Treasurer. The intention will be to provide new investment opportunities. She drew the Committee's attention to a chart in the report which showed endowment fund investment management fees for The Regents and for the foundations' external managers. The cost of having funds managed by the Treasurer averages 4 basis points, while external managers average 42 basis points.

Regent Khachigian raised the issue of The Regents' fiduciary responsibilities with respect to the performance of the foundations' investments and whether The Regents should consider taking action if the performance continues to be poor.

Regent Hopkinson noted that this issue would be considered in the review of the policies and performance of the foundations. There are presently no policies with respect to the performance of the investments of the foundations.

Mr. Heil stressed the importance of viewing performance within an historical context.

Regent Leach concurred with the need to gain a better understanding of the wide variation in performance from one foundation to another. Regent Hopkinson confirmed that this information would be part of the study.

President Atkinson observed that four campus foundations essentially invest all of their funds with The Regents, while the older campuses have a more independent tradition.

Regent Preuss cautioned that the psychology of the donors must be taken into consideration. Many of them are quite specific about how they wish the money to be managed. In addition, some trustees do not place a high degree of confidence in The Regents. Regent Hopkinson believed that the relationship could be mended over time.

Chairman Johnson pointed out that the foundations that had performed poorly had the highest percentage of externally managed funds.

The meeting adjourned at 10:40 a.m.

Attest:

Secretary