The Regents of the University of California

COMMITTEE ON FINANCE
COMMITTEE ON INVESTMENTS
January 16, 2002

The Committee on Finance and the Committee on Investments met jointly on the above date at Covel Commons, Los Angeles campus.

Members present: ***Representing the Committee on Finance***: Regents Atkinson, Connerly, Hopkinson, S. Johnson, Kozberg, Lee, Montoya, Morrison, and Preuss; Advisory member Ligot-Gordon

Representing the Committee on Investments: Regents Atkinson, Bagley, Davies, T. Davis, Hopkinson, S. Johnson, Lansing, and Lee; Advisory member Ligot-Gordon

In attendance: Regents O. Johnson, Marcus, and Seymour, Regents-designate Sainick and Terrazas, Faculty Representatives Binion and Viswanathan, Secretary Trivette, General Counsel Holst, Treasurer Russ, Provost King, Senior Vice President Mullinix, Vice Presidents Broome, Doby, Drake, Gurtner, and McTague, Chancellors Berdahl, Carnesale, Dynes, Orbach, Tomlinson-Keasey, and Vanderhoef, and Recording Secretary Nietfeld

The meeting convened at 10:50 a.m. with Committee on Investments Chair Hopkinson presiding.

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

Upon motion duly made and seconded, the minutes of the meeting of November 14, 2001 were approved.

2. **TREASURER'S OFFICE COMPENSATION: ANNUAL INCENTIVE PLAN PROPOSAL**

The Committees were informed that at the March 2002 meeting the President intends to recommend approval of the fiscal year 2002-03 Annual Incentive Plan for the Office of the Treasurer, including specific parameters as detailed in the Attachments for the initial year of implementation. Following this initial year, the President, the Chairman of the Board, the Chairman of the Committee on Finance, and the Chairman of the Committee on Investments will jointly approve certain parameters of the plan, including performance measures and objectives. At the beginning of each plan year, the Treasurer will submit a report to The Regents showing approved participants, award opportunity levels, performance measures, and objectives for the coming year.

Participants in the plan and award payments, based on achievement of performance objectives, will be determined by the Treasurer, subject to approval by the President, following the initial year of implementation. The Treasurer's award will be determined by the President and approved by The Regents. At the end of each plan year, the Treasurer will submit a report to The Regents which summarizes the overall results of the plan for the year, including the payment of incentive awards.

Associate Vice President Boyette presented the details of the proposed incentive plan. She reported that, as of June 30, 2001, the Treasurer's Office managed $55.5 billion in total assets. Of this amount, $43.8 billion, or 81.6 percent, is managed internally, and the balance of $11.7 billion is managed by outside portfolio managers. There are currently 48 employees and 8 vacant positions in the Office of the Treasurer, including 6 senior management positions, 14 investment professional positions, and 36 positions in operations, accounting, banking, and administrative support. Compensation for all staff members other than the Treasurer consists of base salary only, without the opportunity for performance-based incentive pay. The administration believes that an incentive program will be an important component of any offers that are made to potential hires for these vacant positions.

The Office of the Treasurer first discussed with The Regents the concept of a performance-based incentive plan in March 1997. The Office of the President has more recently discussed with The Regents compensation levels in the Office of the Treasurer and a proposal for an Annual Incentive Plan for key management personnel. In those discussions, data were presented that demonstrated significant market lags when comparing UC salaries for management and professional investment staff in the Office of the Treasurer to the competitive market. An updated analysis using the McLagan Partners 2001 Investment Management Compensation Survey indicates current salary lags to the median of 7.3 percent to 51 percent. When comparing total cash compensation (salary plus incentive payments) to the market, higher lags ranging from 67.3 percent to 168.2 percent exist due to the lack of an incentive compensation plan in the Office of the Treasurer.

Compensation plans that include base salary and incentive or a bonus opportunity are designed to link pay with performance and are the norm in the investment industry. Virtually all of the participants in the McLagan Partners Survey provide incentive pay as part of their compensation programs. In an environment of increased market volatility and the need to hire high-quality investment professionals, an incentive plan is essential for attracting and keeping key employees, as well as focusing attention on performance. Today's discussion is intended to present specific design parameters for the proposed Annual Incentive Plan for the Office of the Treasurer. These parameters have been developed in conjunction with the compensation consulting firm of William M. Mercer, Inc. and the Treasurer of The Regents. The incentive plan would provide key managers with non-base building, annual incentive bonus payments. The University engaged Mercer to lead the plan development to provide objective, third-party advice and expertise in incentive plan design.

Incentive Plan Design

The primary purposes of the incentive plan for the Office of the Treasurer are to motivate and reward achievement of specific objectives based on the performance of the investment portfolio and other predetermined goals and to provide a more competitive compensation package to attract and retain highly qualified investment professionals. The general design considerations of the incentive plan are outlined in Attachment A. The plan has been designed to reinforce three specific goals that were identified during its development:

- *Long-term Focus*: The overall investment objective for all funds under management is to maximize real, long-term total returns, while assuming appropriate levels of risk.

- *Teamwork*: It is critical that the plan support a cohesive team and not cause internal competition which would ultimately inhibit the performance of the Office and detract from the ultimate goal of serving the University.

- *Recruitment and Retention*: The Treasurer's Office competes in an environment comprised primarily of for-profit investment management firms which historically pay significant incentives, frequently multiples of base salary. The Treasurer's Office does not expect to compete at that compensation level, but does feel it is necessary to offer an incentive plan with meaningful award opportunity levels in order to attract and retain its key employees.

During the development of the incentive plan, a review was made of the CalPERS incentive plan, which currently covers 30 top management and investment professional positions. In many respects, the proposed UC incentive plan is similar to that of CalPERS . A comparison of the proposed Treasurer's Annual Incentive Plan to the CalPERS plan can be found in Attachment H.

The proposed performance objectives of the incentive plan are set at levels that are greater than benchmark returns on separate asset classes. The plan is designed to pay awards only for results that exceed those that could be achieved by simply indexing assets to appropriate benchmarks in a passive manner plus a nominal spread over the benchmark.

Plan Costs

The incentive plan will be funded via a charge to assets under management. The Treasurer's Office management fee is low relative to external investment management firms. This provides attractive cost savings and, therefore, potentially higher returns. Expenses for investment management and operations are only about 0.04 percent of assets under management (including 0.02 percent for Office of the President corporate accounting), compared to the industry average of 0.60 percent. An incentive plan covering senior managers and the professional investment and trading staff (21 positions) in the Office would cost about $1.3 million per year, and add only about .0023 percent to total expense at the target level of performance. Under the proposed design, the first year's cost is one-third this amount, the second year's cost is two-thirds, and full cost occurs in the third year of implementation. At the maximum level of performance, the plan would cost approximately $1.9 million annually. In contrast, if total entity performance achieved a 50 basis points improvement over benchmark returns, this would result in over $250 million in added value to the portfolio. Because the plan provides non-base building incentive payments, it leverages compensation so that fixed costs such as base salary and benefits are controlled. The variable cost of incentives will fluctuate according to the performance of UC's investment portfolio and the performance of individuals and groups within the Treasurer's Office.

Ms. Diane Doubleday of Mercer presented slides that depicted details of how the incentive plan would be triggered by individual performance. Because the payout as a percentage of award opportunity will be capped at 150 percent, participants will not be encouraged to take unnecessary risks in order to achieve higher returns. The goal for the plan is to achieve target levels of performance on an ongoing basis. Another important feature of the plan is a funding trigger intended to emphasize the importance of total portfolio returns. Every participant in the plan has a portion of his or her award tied to The Regents' performance. Individual goals will not be based upon portfolio returns. The plan also proposes a negative accrual feature. Performance below threshold on certain award components will be penalized by providing a negative amount for that component of the participant's award. Attachment F provides details and examples.

Ms. Doubleday reported that Mercer had used the CalPERS incentive plan in formulating the design of the proposed incentive plan for the Office of the Treasurer. She noted that while UC and CalPERS use different external indices to benchmark performance, UC's plan will require a higher level of performance above the benchmark for target award payouts.

Regent Montoya asked for information on the negative accrual feature of the plan. Treasurer Russ explained that stringent metrics would be applied to each analyst and portfolio manager. If an analyst in a particular sector were to lose less money than the benchmark, this would be considered to be excess performance, and incentive compensation would be awarded.

Regent Connerly asked for evidence that there is a correlation between an incentive plan and individual performance.

Senior Vice President Mullinix believed that the implementation of an incentive plan for the Office of the Treasurer would result in more tracking of individual performance. Ms. Doubleday could not cite any specific studies that indicated such a correlation. She did find that employees were more motivated once performance goals had been set.

Regent Connerly asked whether or not consideration had been given to offering incentive plans for other units within the Office of the President such as the Office of the General

Counsel. Ms. Boyette noted that some legal firms do have incentive packages. Data show that the practice is universal in the investment community.

President Atkinson added that the fact that the faculty undergo rigorous performance evaluations had contributed to the University's excellence as a public institution.

Regent Connerly asked why the incentive plan did not include all of the staff in the Treasurer's Office, noting that lower-level employees also contribute to improved performance. Senior Vice President Mullinix commented on the difficulty of measuring the contributions of staff who are not directly involved in investments. In addition, many of the positions are comparable to those of other clerical workers within the University.

Regent Davies believed that an incentive compensation plan for the Treasurer's Office was overdue and should contribute to the quality of the staff who manage The Regents' assets. He suggested that, before the Regents vote on the proposed plan, they should be provided with data showing how an incentive plan would have worked for the past three years.

Regent Marcus spoke to the importance of having subjective performance measures.

Regent Lansing observed that incentive awards would be matched to a benchmark and asked whether there were any plans that do not offer awards when the participant loses money. Vice President Mullinix responded that some incentive compensation plans have a trigger based on the performance of the fund. This option was discussed internally, and the conclusion was reached that stellar performance should be awarded even if the overall fund did not perform well. He confirmed for Regent Lansing that the requirement that a participant not lose money even in bad economic times would impinge on the Office's ability to recruit qualified personnel.

Regent Lee believed that the plan should be flexible enough for the Treasurer to be able to make changes as needed.

The meeting adjourned at 11:30 a.m.

Attest:

Secretary