The Regents of the University of California

COMMITTEE ON INVESTMENTS
INVESTMENT ADVISORY COMMITTEE
October 29, 2002

The Committee on Investments and the Investment Advisory Committee met jointly on the above date at the Morgan Center, Los Angeles campus, and by teleconference at UCSF-Laurel Heights, San Francisco.

Members present: ***Representing the Committee on Investments***: Regents Ligot-Gordon, Montoya, Moores, Parsky, Pattiz, Preuss, and Saban

Representing the Investment Advisory Committee: Regents Hopkinson and Parsky, Senior Vice President Mullinix representing President Atkinson, Mr. Russell Gould, Mr. William Hambrecht, and Mr. John Hotckhis; Consultants Cambon, Keller, and Lehmann

In attendance: Regent Kozberg, Regent-designate Murray, Faculty Representative Binion, Associate Secretary Shaw, General Counsel Holst, Treasurer Russ, and Recording Secretary Nietfeld

The meeting convened at 1:10 p.m. with Committee on Investments and Investment Advisory Committee Chair Parsky presiding.

1. **PORTFOLIO ANALYSES AND INVESTMENT TRANSACTIONS (QUARTERLY REPORT)**

Treasurer Russ reported that for the quarter ended September 30, 2002, the return for the University of California Retirement Plan (UCRP) was negative 8.5 percent, which compares favorably with the return for the benchmark of negative 9.4 percent. There were similar results for the General Endowment Pool. Mr. Russ presented the returns by asset class for UCRP, noting that the U.S. equity slightly underperformed for the quarter, while the bond portfolio had a positive return of 7.7 percent versus the return for the benchmark of 6.8 percent. Treasury Inflation Protection Securities had a positive return of 8.1 percent in the quarter.

2. **CORPORATE GOVERNANCE**

Treasurer Russ introduced Mr. Ted White, director of Corporate Governance for the California Public Employees' Retirement System (CalPERS), and Mr. Joe Grundfest, a faculty member at Stanford University and a former commissioner of the Securities and Exchange Commission. Mr. Grundfest observed that an important point to recognize is that the right of shareholders to vote must be managed intelligently. Most institutional investors spend more time on such activities as sector allocations than they do on formulating coherent policies for the maximization of the value of their votes. The questions become how to exercise the value of the franchise and what objectives should be pursued. This issue is particularly difficult for a community such as a university, with a large number of interests represented by a wide variety of agendas that different people have with regard to the exercise of the shareholder franchise. Mr. Grundfest stressed that it becomes crucial to have a coherent principle that manages the vote. He noted that the primary objective when managing a portfolio is to maximize value in order to satisfy the manager's fiduciary obligations. While such an obligation does not mean that other agendas held important by members of the community should not be respected, there are better ways to express these agendas than through efforts aimed at shareholder voting activity. Experience has taught that the effort to reallocate a corporate portfolio as part of the means to achieve a political objective does not assist in doing so. Such a strategy tends to impair investment returns, which is to the detriment of the basic fiduciary obligation of those responsible for investing.

Regent Parsky observed that Mr. Grundfest had raised issues pertaining to the right to exercise shareholder votes and the pursuit of political objectives through the investment portfolio. He asked for Mr. Grundfest's advice on how large institutions such as the University of California should approach the right to vote. Mr. Grundfest reiterated the need to establish a set of policies that are generally applicable to shareholder voting which overall will do more good than harm. This is especially the case for an organization with a large, diversified portfolio. He noted that many large institutional investors had addressed the issue of corporate governance and suggested that much could be learned from consulting with peers such as CalPERS and TIAA-CREF. In response to a comment by Regent Parsky, he confirmed his opinion that an institution which remains passive misses the opportunity to influence corporate performance.

Regent Preuss asked for comment regarding policies which had had harmful consequences, as well as those which were working. Mr. Grundfest observed that, as a broad rule of thumb, the approaches that tend to work are those that are sensible and business oriented. For example, actions by large institutional investors to prevent corporations from adopting plans that threaten to dilute the holdings of existing shareholders have been very effective. In some instances, when the corporation was able to ascertain that the proposal would not receive a favorable shareholder vote, the proposal was not made. At the other extreme are topics which are fueled by political or social agendas; this approach generally tends not to work. One such example would be what actions corporations should take with respect to human rights. Mr. Grundfest noted that while he might agree with the spirit of these proposals, he believed that the possibility that shareholder action could have an effect was remote at best. There are other approaches that tend to achieve better results.

Mr. Nesbitt of Wilshire Associates recalled that a major proxy issue in the 1980s had been divestment from companies doing business in South Africa, at which time institutional investors used proxy voting and other means to effect change. He asked whether Mr. Grundfest would agree with this approach. Mr. Grundfest recalled that the Sullivan Principles related in part to the exercise of the proxy vote in that context. It was his belief that while institutions' use of the proxy vote was an important symbol, it had little to do with the ultimate defeat of apartheid. Opposition to the South African regime, however, achieved a rare degree of universal acceptance within university communities.

Regent Ligot-Gordon asked whether or not The Regents had an obligation to express its views on social or moral issues to the corporations with which it invests. Mr. Grundfest noted that the first step would be to determine the best way in which to achieve a social objective and then develop a list of strategies that institutions could follow. Experience suggests that shareholder voting does not appear at the top of such a list; boycotts and protests are much more effective. He continued that TIAA-CREF had learned that very often the best way to use moral persuasion is behind closed doors. A large percentage of senior managers of large, publicly-traded corporations are decent people who, if given an exit strategy, will discontinue practices that are seen to be immoral or unethical.

In response to a question from Regent Pattiz regarding the Regents' fiduciary responsibility to maximize returns, Mr. Grundfest explained that the strategy which he is suggesting is to consider a proxy vote as an asset which must be managed in order to maximize risk-adjusted returns. This approach is consistent with legal obligations and with strategies that work to promote social change and responsible investment returns.

(At this point Mr. Grundfest left the meeting.)

Mr. White presented a detailed report on **CalPERS Corporate Governance and US Financial Reform Perspectives**, a copy of which had been mailed to the Committee members in advance of the meeting. He informed the Committees that corporate governance refers to the relationship between investors and corporate management in determining the direction and performance of a corporation. Its purpose is to have a demonstrable impact on a corporation's financial performance. In response to the financial crisis in the stock market, CalPERS' Investment Committee adopted a financial market reform program that addresses issues such as the role of audit committees, the independence of a corporation's auditors, and the governance system model. CalPERS is also involved in ongoing programs that are designed to educate and influence its corporate partners. CalPERS has an extensive web site and shareowner forum on which it posts its projected proxy votes prior to shareholder meetings. CalPERS believes that putting issues on the table helps to facilitate better decisions.

Mr. White discussed the focus list program, which is CalPERS' direct engagement in companies in its portfolio. Through an annual selection process, five to ten companies are chosen to participate in this process for a three-year period, during which time CalPERS is actively engaged in improving corporate governance policies. A 2002 study by Wilshire Associates found that the corporate governance approach adds value to performance. Another component of corporate governance is through investment in three active external managers that employ a governance strategy. The current commitment to this strategy is approximately $3 billion, or approximately one percent of CalPERS' externally managed portfolios. Mr. White noted that the performance of these three active managers had been outstanding.

Regent Parsky asked how this strategy differs from that of traditional external portfolio managers. Mr. White explained that a common thread is the level of involvement in the company, which could include membership on its board of directors.

Regent Hopkinson asked what percentage of ownership the investments represent in the companies. She was also interested in the level of staffing that is necessary for CalPERS to implement its corporate governance program. Mr. White responded that the percentage of the ownership varies from two to five percent, although there have been cases where ownership was in the twenty percent range. With respect to how this corporate governance program works, he referred to the case of Tyco, where the focus was on replacing the board of directors in order to address the company's credibility issues in a timely fashion. He indicated that his unit consists of six investment officer positions overseeing the focus list program, proxy voting, and the active management program.

Regent Parsky recalled that concerns that had been raised by Regents in the past with respect to the concentration of stocks in the portfolio, and he asked how CalPERS addresses the issue of risk. Mr. White explained that CalPERS has an in-house dedicated risk-management staff member who is working to aggregate risks across asset classes. Wilshire Associates provides assistance in this area.

Returning to his prepared report, Mr. White discussed CalPERS' proxy voting function, an area which is overseen in the corporate governance unit. Two staff members are dedicated to in-house proxy voting, which becomes intense during the voting season. The Investment Committee reviews and approves proxy voting guidelines in order to provide the parameters within which to vote. He stressed the crucial nature of the staff's being given the independence to vote CalPERS proxies. There is an informal committee that considers the more controversial issues. The office also relies on external sources of information.

Regent Parsky asked about the board's relationship to in-house proxy voting. Mr. White responded that his office reports on decisions taken on a quarterly basis; the board has final authority on the proxy voting guidelines.

In response to a question by Regent Moores regarding option plans and executive compensation, Mr. White recalled that his staff had devoted considerable attention to these issues, culminating in an option workshop which is available on video. The workshop led to an ongoing emphasis on executive compensation in its entirety. CalPERS will perform more research in order to increase its role in this area. Companies are being asked to write compensation policies and have them approved by shareholders.

Regent Pattiz asked whether there was concern about attracting qualified people to serve on corporate boards, given the current climate. Mr. White believed that companies were not willing to take the extra step in identifying qualified candidates, tending to rely on people who will not lend an independent voice. CalPERS often pressures companies to increase compensation for qualified directors who are chosen by the nominating process approved by CalPERS.

In response to a question by Regent Parsky, Mr. White explained that any decision to pursue litigation against a corporation was made through a joint evaluation between the investment office and the Office of the General Counsel, with the board having final authority.

The Committees went into Closed Session at 2:20 p.m.

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The meeting adjourned at 4:15.

Attest:

Associate Secretary