The Regents of the University of California

COMMITTEE ON INVESTMENTS
INVESTMENT ADVISORY COMMITTEE
February 11, 2004

The Committee on Investments and the Investment Advisory Committee met jointly by teleconference on the above date at Covel Commons, Los Angeles campus, and UCSF-Laurel Heights, 3333 California Street, San Francisco.

Members present: ***Representing the Committee on Investments***: Regents Blum, Kozberg, Montoya, and Parsky

Representing the Investment Advisory Committee: Regents Blum, Hopkinson and Parsky, Senior Vice President Mullinix representing President Dynes, Mr. Russell Gould, Mr. John Hotchkis, and Mr. Charles Martin; Consultants Beim, Cambon, Keller, and Lehmann

In attendance: Regent-designate Anderson, Associate Secretary Shaw, General Counsel Holst, Treasurer Russ, Associate Treasurer Stanton, and Recording Secretary Nietfeld

Representing the Campus Foundations: Mr. Peter Taylor, the UCLA Foundation; Mr. Lee Kolligian, the UC Merced Foundation; Mr. Nick Goldware, the UC Riverside Foundation; and Mr. Eric Sonquist, the UC Santa Barbara Foundation.

The meeting convened at 1:35 p.m. with Committee on Investments and Investment Advisory Committee Chair Parsky presiding. Due to the lack of a quorum of the Committee on Investments, the meeting was held as a briefing session for the members in attendance.

1. **QUARTERLY INVESTMENT PERFORMANCE SUMMARY REPORT**

Treasurer Russ commented that the performance reporting format had been expanded to include more detailed information regarding guideline compliance, portfolio composition, and supplemental private equity portfolio information. The quarterly performance for the University of California Retirement Plan (UCRP) was a positive 8.6 percent versus the benchmark performance of 8.3 percent. For the fiscal year to date, the UCRP returned 11.3 percent, while the policy benchmark returned 11.1 percent, and for the fiscal year to date, the return was 22.2 percent as compared with the benchmark's return of 22.5 percent. Mr. Russ noted that the results were similar for the General Endowment Pool (GEP). The market value of the retirement plan stands at $38.74 billion, while the value of the GEP totals $4.69 billion. Treasurer Russ presented some detailed comments on the performance of the UCRP, noting that the U.S. equity portion of the portfolio is invested in an index fund and thus its performance matches that of the benchmark. He pointed to the portfolio market value changes between September 30, 2003 and December 31, 2003, during which time the value of the UCRP increased by $2.88 billion and that of the GEP increased by $302 million, reflecting the recovery in the U.S. stock market.

Regent Parsky observed that until the external management program has been implemented, it will be difficult to assess performance for U.S. equity.

Ms. Kathy Barchick of Wilshire Associates commented on the three measures that are used to evaluate total fund performance, beginning with a comparison to the actuarial interest rate. The 22.2 percent return for calendar year 2003 represents nearly three times the actuarial interest rate of 7.5 percent. A second measure involves a comparison of the performance versus peer institutions. For the year UCRP performed near the medium. Finally, Wilshire takes into account the total fund performance versus the total policy index. The 22.2 percent closely approximated the 22.5 percent achieved by the policy benchmark. The major disconnect was in the area of the private equity performance as a result of the lag effect on the returns in private markets. The Regents' private equity portfolio should outperform the public market by 300 to 500 basis points over the long term. Ms. Barchick noted that the diversification of The Regents' portfolio not only across asset classes but also within asset classes played an important role in 2003, when small-cap stocks outperformed large-cap stocks.

Regent Blum suggested that an issue to be considered was whether private equity would continue to outperform substantially, noting the importance of choosing the right venture capital firms with which to invest.

2. **U.S. EQUITY ASSET CLASS GUIDELINES**

Regent Parsky noted that it would be the intention at the March Regents meeting to recommend that The Regents approve the proposed portfolio investment guidelines for the U. S. Public Equity Asset Class within the University Funds of the retirement, general endowment, and 403 (b) plans, as shown on the Attachment.

Mr. Russ recalled that in November 2002, The Regents approved the recommendation that the equity assets managed by internal staff within the Office of the Treasurer should be reallocated to external equity managers that would be identified, hired, and monitored by staff within the Office of the Treasurer. A staffing plan for the Externally Managed Investment Group within the Treasure's Office was approved, and the group has initiated the first of a series of Requests For Proposal in order to identify and select the external manager firms. The approval of asset class portfolio guidelines is required prior to the hiring of the initial external managers. The existing asset class guidelines for U.S. equity, which were approved in March 2000, were written specifically for the portfolio then managed by the UC Treasurer and thus are not appropriate for the implementation of multiple strategies, each focused on a particular segment of the broad equity market. The proposed guidelines amend the existing guidelines to allow for multiple strategies, while controlling risk for the aggregate of actively managed U.S. equity assets. Treasurer Russ noted that the Office of the Treasurer had worked closely with Wilshire Associates in developing the proposed guidelines.

Ms. Barchick continued that the asset-class guidelines are designed to serve as a broad umbrella for the overall investment program. Any investment manager who is retained will have specific, customized guidelines designed for the firm's unique strategies.

3. **UC FOUNDATION ANNUAL ENDOWMENT REPORT FY 2002-2003**

Treasurer Russ recalled that each year the Office of the Treasurer collects the audited financial statements for each campus foundation. The report focuses primarily on the foundations' endowment assets and their investment performance. Details are also provided regarding the individual foundation's benchmark. Mr. Russ discussed the UC Berkeley Foundation's financial statement, noting that data are provided for endowed assets, which are generally restricted; non-endowed assets, which may be used for short-term investments; and pledges.

Regent Parsky noted that The Regents has a direct responsibility for oversight of the campus foundations; the goal is to achieve a balance between allowing the foundations to carry out their duties while maintaining the appropriate level of oversight. He commented on the positive relationship that has developed between the Treasurer's Office and the campus foundations.

In response to a comment by Regent Parsky, Treasurer Russ explained that the foundations' benchmarks had been accepted by the University. He recalled that Wilshire Associates had conducted a study of the foundations and had found that all of the benchmarks were within the range provided by The Regents.

Regent Hopkinson pointed out that each of the foundations has a different endowment spending policy and pay-out rate and asked whether The Regents had set a policy to cover this. She failed to discern a relationship between the pay-out rate and the returns. Regent Parsky suggested the need for a series of discussions with each of the foundations about their pay-out rates and how they relate to their investment policies and performance results.

Assistant Vice President Barber confirmed that The Regents had never addressed the issue of whether campus foundations should have a uniform endowment expenditure policy. In the past, the chancellors have argued that each campus has different needs and expectations for its endowment and have requested flexibility in the spending policy. Regent Parsky stressed the need for a connection between the pay-out rate and the investment policy. He noted that the issue will increase in importance as the corpus grows. One purpose of the expenditure policy is to create a reserve that could be used to increase the pay-out rate during difficult economic times.

Mr. Sonquist and Mr. Goldware reported on the philosophies that had led to the establishment of the benchmarks and pay-out rates for their respective foundations.

Regent Hopkinson pointed out that the endowment management fee as a percentage of the market value for the UC Santa Barbara Foundation was significantly higher than others. Mr. Sonquist responded that this charge related to the acceptance of a gift that carried with it a restriction as to the money manager. In response to a further comment by Regent Hopkinson, General Counsel Holst stated that he was not aware of any policy statement by The Regents with respect to acceptance of gifts by the foundations. Mr. Barber continued that the foundations have a variety of policies that cover the acceptance of gifts and the authority of the chancellors and the President to accept gifts, but there is no policy specific to this issue.

4. **IMPLEMENTATION OF GASB 39 AND 40 FOUNDATION FINANCIAL REPORTING**

Assistant Vice President Plotts presented an overview on the implementation of GASB 39. He explained that the Governmental Accounting Standards Board is an independent body that establishes accounting and financial reporting standards for state and local governments, including public colleges and universities. The University's adherence to these standards is the basis for The Regents' auditor, PricewaterhouseCoopers, to issue its unqualified audit opinion. GASB 39, which requires that the campus foundation financial statements be discretely presented in the University's audited financial statements, will result in an increasing need for coordination and communication with the foundations. The discrete presentation of foundation financial statements means that they are not consolidated with those of the University but are shown separately from UC and UCRS. The reporting requirements are effective for fiscal year 2003-04, and FY 2002-03 will be restated.

Turning to the issue of what GASB 39 means for the foundations, Mr. Plotts observed that they will be asked to provide summary financial information to the Office of the President that is timely and on an accelerated schedule, with completion of the audit by September 15 rather than in October or November. The data will be presented to the Office of the President in a standardized reporting format in accordance with written guidelines. The financial statements will be audited by each foundation's external auditor and approved by the foundation audit or finance committee.

In response to a question from Mr. Keller, Assistant Vice President Plotts explained that the Office of the President did not intend to impose any requirements with respect to the external audit firm retained by the foundations. Presently, three different audit firms are used. The foundation's external auditor is required to communicate to PricewaterhouseCoopers as to the validity of the financial statements.

Mr. Plotts observed that foundation management interactions with the audit committee may be out of cycle due to the new September 15 deadline. The Office of the President has worked with the Chief Financial Officers to develop a campus foundation financial reporting package which should ensure that the financial information presented is generally consistent across all ten foundations and also with UC's financial statement and footnote presentation. The package was designed such that there would be no need to modify the foundations' accounting policy elections or financial statement presentation. The package aligns the classification of assets, liabilities, revenues, expenses, and cash flows.

Assistant Vice President Plotts presented the following timeline for the implementation of GASB 39:

- From December 2001 to April 2003, the Office of the President worked closely with campus foundation CFOs and with PricewaterhouseCoopers to develop the approach and the financial reporting package.

- In September 2003, the campus foundations prepared a financial reporting package for the year ended June 30, 2003.

- In January 2004, the University's 2003 financial statements were restated to incorporate campus foundation financial information, and the financial reporting package templates and guidelines were updated for June 30, 2004.

- In September 2004, the campus foundation financial statements will be due to the Office of the President.

Regent Hopkinson pointed out that materials produced by the Office of the President with respect to the foundations do not address The Regents' fiduciary responsibility. She believed that the implementation of GASB 39 and 40 would increase the need for Regental oversight of the foundations. Regent Parsky agreed that it was the responsibility of The Regents to ensure that the foundations provide accurate and timely data.

Mr. Plotts confirmed for Mr. Taylor that the timeline which he had outlined would meet The Regents' requirement for timely information from the foundations. Close coordination between foundation management and foundation audit committees will be necessary to ensure that the deadline is met.

Mr. Keller raised the issue of the additional costs to the foundations resulting from compliance with GASB 39. Mr. Plotts acknowledged that the foundations' auditors would be asked to perform additional procedures. Mr. Sonquist continued that the UCSB Foundation had participated in a pilot program two years ago which resulted in a ten percent increase in audit costs. The foundation issued an RFP for audit services and selected

PricewaterhouseCoopers; as a result, the cost of the audit decreased significantly because the foundation was using the same auditors as The Regents.

Mr. Hotchkis asked whether the foundations are restricted from investing in tobacco stock. General Counsel Holst did not recall that The Regents had ever adopted such a policy. Regent Parsky pointed out that The Regents had provided guidelines pertaining to asset allocation and benchmarks but had not required the foundations to follow the policies that guide the investments of The Regents, thereby respecting the need for flexibility on the part of the campus foundations. He noted that this issue could be revisited.

In response to a question from Regent Blum, Regent Parsky explained that the only restriction imposed on the Treasurer was the prohibition against investing in tobacco stocks.

Assistant Vice President Plotts discussed the implementation of GASB 40, which will require expanded disclosure by the University and the campus foundations of investment types and policies in the financial statements beginning in June 2005. Deposit risk concepts and disclosure must be applied separately to financial statements for the University, each UC entity that has separately audited statements, and each campus foundation. In addition, investment risk concepts and disclosure must be applied separately to those entities listed above as well as to the UCRP, the 403(b) Plan, and PERS-VERIP. GASB 40 requires that the University disclose its investments by type of investment, moving from 11 to over 30 categories. It requires a discussion of credit risk ratings and credit quality ratings as measured by S&P or Moody’s for fixed income securities, by each investment type. GASB 40 is also intended to address custodial credit risk, defined as the risk that if, in the event of the failure of the custodian, the deposits or investments may not be returned. The University’s deposit policy is to use financial institutions with a minimum “A” rating. GASB 40 also asks that the University disclose the risk associated with a lack of investment diversification, specifically whether any one issuer represents five percent or more of the portfolio value. The statement will require disclosure of interest rate information for each type of fixed income securities and identification of any unique investment terms for securities that are highly sensitive to interest rate changes. The University will be required to set out any risk of exposure to fluctuations in foreign currency denominated equity or fixed income securities. Assistant Vice President Plotts noted that for the University, GASB 40 will significantly expand audited information in the areas of investments, securities lending, and investments held by trustees. There will be ongoing coordination between the Financial Management Group, the Office of the Treasurer, and the campus foundations. A large amount of audited information will need to be organized and accumulated in a timely manner. For the foundations, GASB 40 will result in more communication and coordination with the University. The Office of the President will receive substantial information that has been audited by the foundation's external auditor and approved by the foundation's audit or finance committee.

Mr. Plotts presented the following timeline for the implementation of GASB 40:

- November 2003 to January 2004: Discussions with PricewaterhouseCoopers regarding the University's approach.

- February to March 2004: Draft amendments to the campus foundation Financial Reporting Package.

- November to December 2004: Restate 2004 UC financial statements.

- September to October 2005: Prepare 2004-05 UC statements with new requirements.

Consultant Lehmann observed that the implementation of GASB 40 would be burdensome for those campus foundations whose investments are not managed by the Treasurer's Office.

Mr. Goldware suggested that the use of a single accounting firm to perform the required audits for the University and the foundations would keep costs down. Regent Parsky asked the foundations to consider that idea, noting that some foundations prefer greater independence than others. Mr. Sonquist observed that the funding source used by the foundations to offset increased costs includes the endowment cost-recovery fee and suggested that the Regents might wish to look at that structure in light of the dramatic changes that will result from the implementation of GASB 40.

Ms. Barchick reported that the issues represented by the annual endowment report and the implementation of GASB 39 and 40 were consistent with the campus survey performed by Wilshire in 2002. Five recommendations were highlighted in the Wilshire report, ranging from policy development to standardization of reporting. The new requirements will represent a step forward, particularly with respect to standardized reporting.

5. **REQUEST FOR PROPOSAL FOR RECORD KEEPING AND INVESTMENT OPTIONS FOR NEW 457(b) PLAN WITH POTENTIAL FURTHER APPLICATIONS**

The Committee was informed that early in 2004 UC HR/Benefits, in partnership with the Office of The Treasurer, will solicit bids from firms that offer record keeping and investment education services, in connection with consideration of the feasibility of adding a new 457(b) deferred compensation plan. As part of this process, UC intends to solicit proposals from qualified firms who could provide external investment options for faculty and staff for a 457(b) plan, with possible further application to UC's Defined Contribution Plan and Tax-Deferred 403(b) Plan. The primary goal of this project is to review the suitability of any of the external investment options available to UC participants relative to other external options available in the marketplace.

The 403(b) Plan offers six investment options managed by the Office of the Treasurer and investment options through two external vendors. The DC Plan offers the same six UC-managed investment options and investment options through one external vendor. Participants in the 403(b) Plan have had the ability to direct their tax-deferred contributions into socially responsible mutual funds through The Calvert Group since 1985. Fidelity Investments was added as a third-party vendor of investment options for the 403(b) Plan in 1987 and for the DC Plan in 1994. As of June 30, 2003, the value of UC participant investments with these two external vendors exceeded $1.5 billion. By comparison, UC participant investments in the six UC-managed funds were valued at more than $6.9 billion as of June 30, 2003.

Bid Process

A cross-functional team comprised of staff from UC HR/Benefits, the Office of the Treasurer, the Office of the General Counsel, and local campus Benefits Offices has been working with Aon Consulting to develop the request for proposals. The project is being overseen by an internal Steering Committee that includes the Senior Vice President–Business and Finance, the Treasurer, and the Associate Vice President for HR/Benefits. An extensive consultation and review process has been initiated and will continue through the conclusion of this vendor search and selection project.

6. **REQUEST FOR PROPOSAL FOR REGENTS' INVESTMENT CONSULTANT**

Senior Vice President Mullinix recalled that a copy of the Request for Proposal for The Regents' investment consultant had been distributed to the members of the committees in advance of the meeting. The contract with Wilshire Associates will expire on March 31, 2004; the goal is to have a new contract for the committees' May 4 meeting.

Regent Parsky explained that the intention would be to appoint a selection committee that would include representatives from the Investment Advisory Committee, The Regents, and the Office of the President to formulate a recommendation to the Committee on Investments. He commented that Wilshire Associates had done an outstanding job for The Regents.

Mr. Martin suggested that the following language be included in the RFP:

> To develop and recommend investment program strategy for the University, with specific emphasis on the next three years. This strategy should reflect a thoughtful assessment of the investment landscape anticipated during that period and key scenarios that are likely to emerge along with the related investment decision

implications. The strategy should thoughtfully consider the balance between risk management and opportunity selection.

Regent Parsky understood the wording proposed by Mr. Martin to suggest the need for a review of the asset allocation plan itself. Mr. Martin noted that the review should include strategies within each asset class. He stressed the importance of the quality of the advice that the consultant would be expected to provide. Regent Parsky agreed that the emphasis should be on the needs of the UC system.

Senior Vice President Mullinix noted that, in addition to advertisements, the RFP is provided to firms to encourage response and interest. He asked to be provided with information on any firms that the Regents or advisory committee members wished to be included. Mr. Keller commented on the fact that firms may have certain areas of specialized expertise. He suggested that the University should not be locked into large investments in any particular asset class.

Regent Blum agreed with the idea of developing a three-year plan, but he agreed that, given the University's economic position, it would be important to maintain some flexibility in the investment plan.

Regent Hopkinson commented on the outstanding role played by Mr. Steve Nesbitt, formerly of Wilshire Associates, in providing investment advice to The Regents.

The meeting adjourned at 3:15 p.m.

Attest:

Associate Secretary