The Regents of the University of California

COMMITTEE ON INVESTMENTS
INVESTMENT ADVISORY COMMITTEE
August 17, 2004

The Committee on Investments and the Investment Advisory Committee met jointly by teleconference on the above date at the following locations: UCSF-Laurel Heights, 3333 California Street, San Francisco; James E. West Alumni Center, Los Angeles campus; and 3350 Deer Park Drive, Suite A, Stockton.

Members present: ***Representing the Committee on Investments***: Regents Anderson, Lee, Montoya, Ornellas, Parsky, and Pattiz; Advisory member Blumenthal

Representing the Investment Advisory Committee: Regents Lee and Pattiz, Senior Vice President Mullinix representing President Dynes, Mr. David Fisher, Mr. William Hambrecht, Mr. John Hotchkis, Mr. Charles Martin; Consultant Beim

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

The meeting convened at 1:45 p.m. with Committee Chair Lee presiding.

1. READING OF NOTICE OF MEETING

For the record, it was confirmed that notice was served in accordance with the Bylaws and Standing Orders for a Special Meeting of the Committee on Investments and the Investment Advisory Committee for the purpose of addressing items on the Committees' agenda.

2. APPROVAL OF MINUTES OF PREVIOUS MEETING

Upon motion duly made and seconded, the minutes of the meeting of July 14, 2004 were approved, Regents Anderson, Lee, Montoya, Ornellas, Parsky, and Pattiz (6) voting "aye."[1]

3. QUARTERLY AND FISCAL YEAR INVESTMENT PERFORMANCE SUMMARY AND RISK REPORT

Treasurer Russ presented performance results for consolidated assets for the quarter ending June 30, 2004, the fiscal year-to-date, and the calendar year-to-date, noting that the fiscal year-to-date total return for the University of California Retirement Plan (UCRP) was 14.34 percent, versus the policy benchmark's return of 14.05 percent, thereby adding 29 basis

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[1] Roll call vote required by State law for all meetings held by teleconference

points of value. The return for the General Endowment Pool (GEP) was 14.65 percent versus its benchmark at 14.59 percent. These two portfolios have different benchmarks and different asset allocations. The High Income Pool had a negative return; its objective is to provide income to endowments that require payouts greater than those from the GEP. The return for the Short Term Investment Pool was 3.35 percent. The entity, which represents the entire portfolio, returned 12.42 percent versus its benchmark at 11.9 percent. The Regents' portfolios at June 30, 2004 totaled $59.087 billion.

Turning to the market value changes in The Regents' portfolios, Treasurer Russ reported that at year end the value of the UCRP was $39.289 billion as compared with $39.801 billion on March 31, 2004. Cash flow out of the pension plan included $1.122 billion to UC retirees, while employee service-credit buybacks and accrued versus actual cash payment of fiscal year-end benefit payments reduced the net change in cash flows to $1.04 billion. The increase in asset value due to investment activity for the UCRP was $4.955 billion, and the net change column reflects these outcomes. Similarly, the payout from the General Endowment Pool to beneficiaries was $107 million, while the gain due to investment activity was $504 million, resulting in a net change of $397 million.

Treasurer Russ briefly highlighted investment returns for the UCRP. He reported that fixed income had had a negative return which was close to that of the benchmark as a result of rising interest rates. The asset allocation policy was amended in 2002 to include an investment in Treasury Inflation Protection Securities (TIPS); this investment continues to perform well. Non-U.S. equity had a positive return of 32.43 percent compared with 32.03 percent for the benchmark. The portfolio is overweighted in U.S. equity and international equities and underweighted in U.S. bonds. Private Equity returned 18.41 percent, but the policy benchmark, which is the Russell 3000 Index Plus 3 percent, lagged one quarter, returning 41.90 percent. The relative negative performance of private equity reduced the performance relative to the benchmark from 53 basis points to 29 basis points.

Treasurer Russ commented on the performance of the General Endowment Pool, noting that the total return for the fiscal year-to-date was 14.65 percent. The Absolute Return asset class outperformed its policy benchmark, while the real estate assess class produced an 81.42 percent return due to the successful sale of the Strawberry Shopping Center in Mill Valley. The proceeds from the shopping center were reinvested in the GEP.

(For speakers' comments, see the minutes of the August 17, 2004 meeting of the Committee of the Whole.)

4. **REGENTS' INVESTMENT CONSULTANT ASSET ALLOCATION STUDY**

Senior Vice President Mullinix recalled that the appointment of Richards & Tierney as The Regents' investment consultant had been approved at the July meeting, and he invited the representatives of the firm, Mr. Tom Richards and Ms. Ann Posey, to present their report.

Ms. Posey explained that the mission of Richards & Tierney is to work with investors to improve the management of their portfolios, thereby meeting or exceeding objectives through value-added strategies and the management of risk. The firm is proud of the long-standing relationships it has with its clients, which are based both on trust and an alignment of philosophies. Richards & Tierney believes that a disciplined, consistently applied approach is critical to the success of an investment program. Informed manager selection, appropriate benchmarks, and careful structuring are integral to a successful program. A comprehensive investment information system that is integrated into the decisions that are made is essential. Ms. Posey displayed the qualifications of the professional staff, a representative client list, and examples of the publications of members of the firm. She drew particular attention to the firm's relationship with the University of Minnesota, noting that Richards & Tierney must communicate complicated issues to members of the Board, which is comprised of members with different backgrounds. She anticipated that a similar relationship would develop between her firm and The Regents.

Mr. Tierney provided an outline of the investment consulting services that the firm provides, as well as a performance evaluation for a sample client, Fund Sponsor ABC, that was presented to the consultant search committee. He noted that for any portfolio, the amount of risk is a function of the financial strength of the organization and the funding status of the plan itself. It is important for Richards & Tierney to understand the risk tolerance of the fiduciaries who are responsible for the fund. The services involved with a performance evaluation for a client include identifying appropriate benchmarks for the portfolio managers as well as an analysis of the policy allocation. Mr. Tierney outlined the properties of a valid benchmark, which include the following: unambiguous, measurable, investable, appropriate, specified in advance, and reflective of current investment opinion. He discussed the performance of Fund Sponsor ABC over a fifteen-year period, noting that the six most important elements that related to performance were the following:

- Net Contributions (Preservation of Capital)
- Risk-Free Asset (Preservation of Purchasing Power)
- Investment Policy (Real Return)
- Style Bias (Managers' Benchmarks)
- Managers' Contribution (Value Added)
- Allocation Tactics (Rebalancing Strategy)

Mr. Tierney reported that, since its retention by The Regents, the firm had devoted time to affirming the manager selection process that had been undertaken by the Office of the Treasurer. There was a review of the Request for Proposals and the quantitative and qualitative screening criteria. The firm analyzed portfolio risk and return characteristics as well as the data that the investment managers had provided. Richards & Tierney is in a position to affirm the investment manager selection process, as well as the decision by The Regents to move to active management. Mr. Tierney presented an overview of the R&T work plan for the University of California, as follows:

- Asset Allocation Review for the University of California Retirement Plan and the General Endowment Pool
- Review and Comment on Investment Policy and Assist in Risk Budgeting Process
- Performance Evaluation
- Installation of R&T Analytical Software

Mr. Martin expressed concern about the benchmark currently in place for the General Endowment Pool and the way in which it can skew investment results. He encouraged Richards & Tierney to address this problem. Mr. Tierney agreed that there was a need to identify a more appropriate benchmark for the GEP which would better reflect the fund's performance.

In response to a question from Mr. Beim with respect to the time frame of the work plan, Mr. Tierney responded that the asset allocation and asset policy statements were high priorities. He anticipated being able to present a report to the Committees in November.

Mr. Beim raised the issue of whether Richards & Tierney would be working with the campus foundations with respect to their portfolios. Regent Parsky observed that the Regents have an overall responsibility to assure that the foundation portfolios are safe. In connection with the campus foundation annual review, it will be important to have assurance that the policy guidelines issued by The Regents are in place. He did not feel that more intense scrutiny was required.

In response to a question from Mr. Hotchkis, Senior Vice President Mullinix reported that the annual fee was $375,000 for the next three years, which is lower than that paid to Wilshire Associates. He confirmed for Regent Parsky that the contract contains a termination clause.

5. U.S. EQUITY MANAGER SEARCH UPDATE

Mr. Robert Bladgen, the Managing Director of Externally Managed Investments, recalled that in August 2003 he had described for the Committees the procedure to be followed in the search for external managers. He reviewed The Regents' asset allocation guidelines for domestic and international equities, noting that initially 25 percent of the domestic equity assets would be put into active strategies designed to maximize outperformance at acceptable levels of risk. The styles and capitalizations will be complementary and varied. For international equities, more of the total assets will be invested in active strategies, reflecting the belief that there are greater inefficiencies outside the United States. Mr. Bladgen commented on the organization chart of the Externally Managed Investment Group in the Treasurer's Office, noting that only two positions remain vacant. He presented a schematic of the external manager selection process, noting that, following receipt of the Requests for Proposals, the minimum requirements are reviewed by the Treasurer's Office, there are qualitative and quantitative reviews, and site visits are made to finalist managers.

Mr. Bladgen provided updated timeline projections for the retention of domestic small-cap, domestic large-cap, and international developed equity. The search for the small-cap managers began and was concluded on time. While the search for large-cap managers was somewhat delayed due to the change in investment consultants, the Office is proceeding with the final steps of negotiating fees and choosing a manager combination to fund. The international RFP process is anticipated for the second quarter of fiscal year 2004. Mr. Bladgen provided a chart which displayed the number of days required for each step following receipt of the RFP and presented a list of the nine small-cap managers that have been funded with approximately $1 billion of the University's retirement and endowment assets. He noted that the fee types for these managers are either asset or performance based, with six of the nine managers having been assigned to performance-based fees. The average fee will be a function of actual performance relative to the benchmark, ranging from 50 percent to 150 percent of asset-based fees. The normal asset-based fee is earned when the gross out-performance of the benchmark is approximately four percent, resulting in a performance fee of 79 basis points. If this level of performance is not achieved, the managers will not be paid as much as they would be otherwise. Performance fees are based on a three-year rolling performance history. Mr. Bladgen confirmed for Regent Lee that the fees paid to large-cap managers would be substantially less than those paid to small-cap managers, as small-cap managers are expected to produce better results.

The Committees went into Closed Session at 2:55 p.m.

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The Committees went into Closed Session–Regents Only at 3:25 p.m.

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The meeting adjourned at 3:30 p.m.

Attest:

Anne L. Shaw

Associate Secretary