The Regents of the University of California

COMMITTEE ON INVESTMENTS
INVESTMENT ADVISORY COMMITTEE
May 4, 2004

The Committee on Investments and the Investment Advisory Committee met jointly by teleconference on the above date at the James E. West Alumni Center, Los Angeles campus; 2223 Avenida de la Playa, #220, La Jolla; and 1133 Connecticut Avenue, N.W., Suite 700, Washington, D.C.

Members present: ***Representing the Committee on Investments***: Regents Blum, Parsky, and Preuss; Advisory member Blumenthal

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

In attendance: Secretary Trivette, General Counsel Holst, Treasurer Russ, Assistant Treasurer Stanton, Mr. John Hotchkis, and Recording Secretary Nietfeld

The meeting convened at 1:30 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. **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 purposing of addressing items on the Committees' agenda.

2. QUARTERLY INVESTMENT PERFORMANCE SUMMARY AND RISK REPORT

Treasurer Russ presented performance results for the quarter ending March 31, 2004, the fiscal year-to-date, and the calendar year-to-date, noting that total assets had grown from $53.24 billion to $59.367 billion. The fiscal year-to-date total return for the University of California Retirement Plan (UCRP) and for the General Endowment Pool (GEP) was 14.7 percent, with a slight overperformance by the UCRP relative to the benchmark and a slight underperformance by the GEP. The University's Short Term Investment Pool has grown to $7.7 billion, with a return of 4.2 percent for the fiscal year-to-date and 0.9 percent for the quarter. Treasurer Russ presented some detailed comments on the performance of the UCRP, noting that the U.S. equity component of the portfolio had contributed returns of 18.8 percent. Because the U.S. equity portion of the portfolio is invested in the Russell 3000 index fund, its performance matches that of the benchmark. He noted that the Treasurer's Office is in the process of converting U.S. equity from the index fund to active managers.

Treasurer Russ touched on the compliance of the various asset classes in the UCRP with the asset allocation targets and explained that both U.S. equity and private equity were not within range compliance, with U.S. equity overweighted at 59 percent and private equity underweighted at 1 percent. Commitments are being made to increase the allocation to private equity over time. In the meantime, the variance is invested in U.S. equity. There are no investments in real estate; the policy target is 5 percent. In response to a question from Regent Hopkinson, Mr. Russ explained that an offer had been made to an individual to fill the real estate position within the Office of the Treasurer.

Professor Lehmann suggested that Sandhill Econometrics be listed as a benchmark for private equity, and Treasurer Russ concurred with the recommendation.

Turning to the portfolio characteristics of the passive equity portfolio, Treasurer Russ commented that as active strategies are implemented, there will be more deviations from the benchmark. In response to a question from Regent Parsky, Treasurer Russ reported that to date the Office had invested $1 billion in small-cap issues. Turning to the fixed-income portfolio, he noted that the average duration for UCRP bonds is slightly lower than that of the benchmark in anticipation of rising interest rates, while the average maturity and yield are higher than the benchmark. Treasurer Russ displayed portfolio market value changes for the first calendar quarter and the third UC fiscal quarter, noting that an additional table for the fiscal year-to-date had been distributed to the Committees.

Mr. Jesse Phillips, Investment Risk Manager–Office of the Treasurer, discussed risk management based on the document ***Investment Risk Reporting: Total Fund Risk and Absolute Return Portfolio Risk***, a copy of which was mailed to the Committees in advance of the meeting. He explained that the goal of the Treasurer's report on performance is to inform the Regents about the returns that had been achieved and the risks that were taken to earn these returns. In the past, the Treasurer has used holdings-based risk models to analyze the internal equity strategy. Because good risk management involves multiple measures of risk, the Office is also using a returns-based factor model developed by Professor William Sharpe. The method uses 21 different risk factors to cover the global investable universe. Mr. Phillips commented on the use by portfolio managers of standard deviation to compare a fund to a benchmark and to track how the fund moves over time. Normally the risk of The Regents' portfolio and the benchmark should fluctuate in the same pattern, which indicates adherence to a diversified portfolio. Active risk is currently low as a result of the passive management in the U.S. equity area and the strategy in the bond portfolio. Mr. Phillips displayed a graph showing the 21 global risk factors and briefly discussed how they are employed to determine each portfolio's implied risk exposures. These exposures are then aggregated by using current market weights and compared to the components of the policy benchmark. Each factor contributes to total risk based on both its volatility and the covariance of that factor with other factors.

Regent Parsky commented that the information that would be most helpful to the Regents would be how returns should be seen on a risk-adjusted basis. He recalled that when performance was analyzed in the past, no attention had been paid to the amount of risk in the portfolio. Mr. Phillips confirmed that this was the role of the risk management program, noting that risk measurement is the first step in risk management. His presentation was designed to expose the Committees to the tools he employs in this process. Risk will increase as the Treasurer moves away from passive management of the U.S. equity portfolio.

Mr. Phillips continued that the second use of a risk model is to aid in constructing a portfolio. Risk budgeting involves the allocation of risk in proportion to the expected return. A manager will take positions different from the consensus only if there is the expectation to earn excess returns. The size of an active position should depend upon the expected out-performance, the manager's degree of confidence, and the risk it contributes to the rest of the portfolio.

Mr. Phillips then turned to a discussion of the Absolute Returns allocation within the General Endowment Pool and how risk is assessed for this asset class, which represents 5 percent of the GEP. The Office of the Treasurer uses a risk model developed by The Regents' Absolute Returns consultant, Albourne Partners, which is based on returns. The first step in analyzing risk involves the identification of market exposures for each manager and an estimation of the risk. The second step is to estimate the residual volatility that results from security selection decisions. Mr. Phillips referred to a chart which compared policy versus actual allocations for the five main investment strategies for Absolute Returns. The chart indicated that the allocations are within the ranges permitted by The Regents. Absolute Returns risk is measured by the exposure to each factor, the volatility of each factor, and the degree to which factors are correlated.

Regent Parsky raised the issue of the ability to measure the effect an asset class could have on the overall portfolio. Mr. Phillips noted that the risk report would indicate the amount that risk would change, given a small change in the allocation to any one element of the portfolio. Regent Parsky observed that it would be important to arrive at a more condensed report that would give the Regents a sense of the factors that contribute to the risk in the portfolio.

3. **UC FOUNDATION ISSUES**

Treasurer Russ informed the Committees that in April the Office of the Treasurer had sponsored the second annual UC Foundation Investment Forum, where issues had been raised that are of interest to the Committees. Mr. Beim, speaking on behalf of the UC Berkeley Foundation, noted that one of the Foundation's concerns was based upon the court's ruling in favor of the plaintiffs in *Coalition of University Employees, et al. v. The Regents* and what effect that ruling would have on the future of the Vintage Year 2003 venture fund to which the Foundation has committed an investment. Treasurer Russ

reported that the University was in the process of negotiating with several of the venture capital general partners in order to maintain access to future funds. He recalled that Sequoia had asked that the University become a withdrawn partner from Fund 11, which was part of the Vintage Year 2003 fund. The University will seek to invest with the new generation of venture capitalists. He acknowledged that the issue raised by Mr. Beim was a serious matter.

Mr. Keller recalled that an issue raised at the forum had been whether the Treasurer would be able to provide the campus foundations with access to certain asset classes that they cannot afford to invest in individually. Regent Parsky recalled that when Mr. Russ was recruited to fill the position of Treasurer, one of The Regents' objectives had been to provide more services to the foundations. He supported the opportunity for the foundations to invest with The Regents. Mr. Martin added that the foundations may not have the expertise or the staff needed to invest in certain asset classes.

Assistant Treasurer Stanton reported that the University is working with State Street and with corporate accounting to develop a structure that would allow for unitization into shares for the General Endowment Pool, thus providing the foundations with this investment opportunity. Because such a process will be expensive to construct, the University will need to have assurance from the foundations that they are willing to participate.

Dr. Cambon discussed two issues raised by the UCSD Foundation Investment Committee with respect to asset allocation. He recalled that the allocation of 5 percent of the portfolio to real estate had been approved by The Regents more than a year ago; to date, the allocation remains at zero. He asked whether it would be possible to reach the target allocation using an index fund.

Regent Blum believed that real estate may not be an attractive asset class at this time. He suggested that the issue should be looked at for the long term. Mr. Martin concurred that time diversification was important in this asset class. Regent Blum continued that the expectation is that interest rates will rise.

Regent Parsky agreed with Dr. Cambon's observation that, as real estate had been approved as an asset class, there should be a prudent effort for the portfolio to participate in that class.

Mr. Beim suggested that the Treasurer may wish to include Treasury Inflation Protected Securities (TIPS) in the General Endowment Pool. He asked whether, given the prospect of rising interest rates, the Treasurer had given any consideration to investing in foreign bonds. Treasurer Russ confirmed that he had done so. He noted that TIPS are part of the Treasury allocation within the GEP.

Dr. Cambon commented that a second concern of the UCSD Foundation had been the allocation to fixed income of 27 percent. Peer-group endowments tend to have an average allocation of 16 to 17 percent to fixed income, although many are as low as 10 percent. The

foundation suggests that serious consideration be given to reducing the allocation to fixed income in the General Endowment Pool. Treasurer Russ noted that proposed range changes were on the Committees' agenda.

4. **ENDOWMENT PAYOUT**

Assistant Vice President Barber informed the Committees of the President's intention to recommend at the May 19, 2004 meeting of the Committee on Finance and the Committee on Investments that the expenditure rate per unit of the General Endowment Pool for expenditure in the 2004-05 fiscal year shall be 4.60 percent of a 60-month moving average of the market value of a unit invested in the GEP. He noted that the informational item that was mailed to the Committees in advance of the meeting had recommended 4.55 percent.

It was recalled that in October 1998 The Regents had adopted a target endowment expenditure rate of 4.75 percent, with a first-year payout of 4.35 percent. For all future years, the President and the Treasurer committed to review GEP performance, inflation expectations, and the University's programmatic needs and to recommend to The Regents a rate that would provide appropriate increases in the dollar value of the payout. The payout will be distributed in August 2004 for expenditure in the 2004-05 fiscal year. The 4.60 percent rate represents an increase of ten basis points in the rate adopted by The Regents in November 2002 for expenditure in the 2003-04 fiscal year. Typically the payout rate has been increased by increments of five to ten basis points per year.

If the GEP achieves a total return of 15 percent for the 2003-04 fiscal year, the recommended rate of 4.60 percent would produce an increase per-share payout for expenditure in 2004-05 of 3.32 percent over the prior fiscal year. For the first nine months of this fiscal year, ended March 31, 2004, the GEP has experienced a total return of 14.68 percent. Inflation as measured by the Consumer-Price Index has been running at about 1.1 percent over the past year. The President and the Treasurer will continue to review annually the expenditure rate in the context of the performance of the GEP to form their recommendation to The Regents for the continuation or modification of the endowment expenditure rate.

It was noted that the number of shares to which the payout formula applies changes over time. New shares are purchased by additions to the GEP, existing shares experience fluctuation with the financial markets, and some shares are sold. For these reasons, the percentage is expressed on a per-share basis.

Regent Hopkinson pointed out that it was the intention of the Regents that the 4.75 percent goal be achieved relatively expeditiously and thus she supported the proposed increase of ten basis points.

In response to a question from Regent Parsky about the effect of the payout rate on the overall health of the University, Mr. Barber explained that more money would be available for scholarships, fellowships, research funds, and endowed chairs.

Dr. Cambon asked about the rationale for not going to 4.75 percent, which is only 15 basis points higher than the recommended 4.60 percent. Assistant Vice President Barber suggested that doing so could create an expectation in the minds of the fund recipients that may be difficult to fulfill in future years. In addition, some endowments are not spending all of the available income. These factors have encouraged the administration to move slowly. At the time that the 4.75 percent was established as a target, the assumption was made that there would be a total return to the GEP of about 8.5 percent, which is no longer the case. Cambridge Associates has concluded that the payout formula could be increased beyond 4.5 percent without impairing generational equity.

Regent Parsky noted that the increase in the payout rate would signal to the recipients that the University is attempting to cushion what would otherwise be a down period, as was originally intended by The Regents.

5. **PORTFOLIO REBALANCING ACTIVITY**

Treasurer Russ presented a series of slides, copies of which were mailed to the Committees in advance of the meeting, to illustrate portfolio rebalancing activity in the UCRP for the period September 2002 to March 2004 from an overweighting in fixed income and relative underweighting in U.S. and non-U.S. equity to an underweighting in U.S. bonds and an overweighting in U.S. and non-U.S. equity. These actions were based on the expectation that interest rates would rise, as well as a rekindling of equity markets in spring 2003. The rebalancing transaction began in April 2003 with an overweight to equity by 2.5 percent relative to the policy portfolio. As the market rallied, the overweighting grew to 4.5 percent. An overweighting of 5 percent would have required an immediate correction back to neutral. The Treasurer's Office believed that equity markets would rise as the war in Iraq brought about bullish expectations while at the same time U.S. bonds would decline as interest rates rose in response to the increasing budget deficit. Treasurer Russ displayed a series of tables which demonstrated the impact of equity and bond weights on performance for various periods of time.

Treasurer Russ concluded his remarks by noting that the rebalancing policy has had positive results for the UCRP and the GEP portfolios. From September 2002 to March 2004, total assets grew from $47.36 billion to $59.37 billion, with the UCRP growing by $8.54 billion and the GEP by $1.02 billion. The constraints on ranges, however, limit the ability to add value by over and underweighting asset class percentages.

6. **REVISIONS TO REBALANCING POLICY**

Treasurer Russ stated his intention to recommend that the following changes be made to the Allowable Ranges for the various asset classes, as shown in the Attachment: a small increase to both the minimum and maximum range to provide greater flexibility to add value to the Funds through asset allocation. For the main asset classes, U.S. equity and fixed income, it is proposed to increase this range from plus or minus five (5) percentage points to plus or minus ten (10) percentage points around policy.

Mr. Russ pointed out that the underinvestment in illiquid asset classes negates the current rebalancing ranges. He is recommending that an interim allocation be adopted for the purpose of setting rebalancing ranges. This is not a change to the asset allocation policy but a recognition of the fact that the ranges for rebalancing should be set around a neutral position, with the provision that the fundamental allocation between equity and fixed income be preserved.

Regent Parsky asked for an explanation of why the recommendation would not result in a change in the asset allocation policy adopted by The Regents. He noted that, if the new ranges are approved, the Treasurer would have the authority to invest up to 75 percent in U.S. equity without being out of compliance.

Mr. Beim asked about a time limit for the proposed interim allocation. Regent Preuss believed that the rebalancing would result in a change in the asset allocation policy.

Regent Hopkinson expressed her confidence in Treasurer Russ but suggested that Regental policy should not be based upon confidence in individuals. She did not support giving the Treasurer the amount of flexibility contained in the proposal but rather suggested that such flexibility should be approved by The Regents on a short-term basis only as required by market circumstances.

Regent Preuss believed that it would be appropriate to allow the Treasurer sufficient time to return to the target ranges in times of instability. Treasurer Russ responded that he does have that authority, with the requirement that he report any noncompliance to the Committee.

Mr. Martin expressed concern about having 30 percent of assets in fixed income with a seven-year duration. He believed that while a reduction in that exposure could have positive results, the question arises as to how the funds should be invested.

Mr. Keller supported the Treasurer's need for more flexibility in light of the underweighting of private equity and real estate in the portfolio. He pointed out that peer institutions have invested in many different asset classes and suggested that the asset allocation policy should be revisited.

Treasurer Russ noted that once The Regents' general investment consultant is retained, the firm will wish to review the asset allocation policy.

Regent Parsky suggested that the Treasurer amend his recommendation to seek flexibility in the target ranges for a certain time period. The members of the Committee concurred with this proposal.

7. **IMPACT OF VENTURE CAPITAL ON UC PRIVATE EQUITY RETURNS**

Treasurer Russ reported that, based upon capital market assumptions made by Wilshire Associates in January 2003, private equity was expected to return 11 percent, or 300 basis points above U.S. equity. An alternate case which would adjust for the top tier firms having been removed from the opportunity set would result in returns of 9.5 percent. During the period July 1993 through June 2003, total private equity returns totaled 26.5 percent, while the return for UCRP equity was 8.8 percent and bonds was 10 percent. Without venture capital in the portfolio, the UCRP total return of 10.1 percent would have been reduced to approximately 9.7 percent. The actual dollars returned from ongoing investment in private equity was $2.2 billion over the time period 1978-2003. The recent court ruling in *Coalition of University Employees, et al. v. The Regents* has placed external economic constraints on the portfolio by excluding top-tier venture capital in the future.

Mr. Beim asked whether, absent investments in venture capital, the retirement plan would have been able to fund its liabilities. Treasurer Russ responded that while the asset class did not have a major impact on the UCRP, it does assist in putting off the date when contributions are required.

Regent Blum requested that a more detailed discussion of the whole private equity universe be scheduled. He commented on the generational shift that is taking place in venture capital. Regent Parsky suggested that a special session be held that would consider approaches to private equity investing that are taken by other institutions. He pointed out that Director Berggren is well qualified in this area and suggested that she be asked to make a presentation on the process she follows in the selection of managers.

Regent Preuss believed that a greater effort should be made to communicate to the retirement plan's constituents the detrimental effects of the ruling in *Coalition of University Employees, et al. v. The Regents* on the University's ability to invest in venture capital. Regent Parsky agreed, noting that an attempt would be made to identify some recommendations pertaining to steps taken in other states, such as legislation.

8. **INDEMNIFICATION OF PRIVATE EQUITY GENERAL PARTNERS**

The Committees were informed that the President intends to recommend that the Committee on Investments recommend that The Regents authorize the President and his designees, after

consultation with the General Counsel, to enter into limited partnership agreements in connection with private equity investments, notwithstanding the fact that such agreements may require assumption by the University of liability for the conduct of persons other than University officers, agents, employees, students, invitees, and guests.

General Counsel Holst recalled that The University invests in private equity partnerships by entering into limited partnership agreements as a limited partner. It is customary in such partnership agreements for the limited partners to indemnify the general partner and its members, partners, officers, shareholders, directors, agents, consultants, and employees; the management company and its members, partners, officers, shareholders, directors, and employees; members of the advisory committee (solely with respect to actions or omissions in such capacity); and limited partners represented by members on the advisory committee (solely with respect to actions or omissions in such capacity) against claims, losses, and liabilities incurred in connection with the defense of any actual or threatened action or proceeding to which the indemnified party may become subject in connection with the partnership. Indemnification is given only for actions in good faith and in a manner reasonably believed to be consistent with the partnership agreement and in the best interest of the partnership. No indemnification is given for gross negligence, reckless disregard of duties, material breach of the partnership agreement or willful misconduct of the general partner or management company or affiliates, or for willful misconduct or bad faith of a member of the advisory committee or a limited partner represented on the advisory committee. General Counsel Holst stated the opinion that the form of indemnification is broader than that permitted by the current delegation of authority with respect to liability found in Standing Order 100.4(dd)(9).

The Office of the President believes that the benefits to the University from maintaining its private equity investments outweigh the additional potential risk that may result from conforming to the standard liability. As a result, it is recommended that additional authority be granted for the limited purpose of executing such private equity limited partnership agreements.

In response to a comment by Senior Vice President Mullinix, Mr. Holst confirmed that the recommendation would require approval by the Committee on Finance.

Regent Parsky suggested that the members of the Committee on Investments be asked to comment on whether or not this type of indemnification is a uniform request made by the general partners.

Mr. Martin commented that his experience with partnership agreements suggested that the recommendation pertaining to indemnification went beyond what would be considered to be usual and customary, which is when the general partners are indemnified by the fund, not by individual limited partners in the fund. The individual limited partners need to approve the fund agreements which provide the indemnification.

General Counsel Holst proposed that the private equity staff in the Treasurer's Office be asked to determine common industry practices with respect to the indemnification of private equity general partners.

Mr. Martin stressed that the liability of an investor should not be extended beyond the commitment to the fund. The indemnification is shared by all of the individual limited partners. Treasurer Russ commented that this requirement is presented as part of the partnership agreement.

In response to a question from Dr. Cambon, Mr. Russ explained that previous agreements had been handled on a case-by-case basis. General Counsel Holst continued that the intention of the recommendation had been to recognize the fact that Regental approval is required. Regent Parsky requested that the University's practices in this area be clarified.

9. **REGENTS' INVESTMENT CONSULTANT REQUEST FOR PROPOSALS**

Senior Vice President Mullinix recalled that the contract with Wilshire Associates as The Regents' investment consultant had expired on March 31. The University solicited proposals through the RFP process and received 15 responses. A number of consultants have been interviewed; the Office of the President is in the process of performing additional due diligence. A firm will be chosen in the near future, and a recommendation will be made to the Chair of the Committee.

Regent Parsky commented on the importance of having a consultant who is available to and responsible to The Regents. It was never contemplated that the consultant would be engaged in fund management or in the selection of managers. He asked that Senior Vice President Mullinix outline for the Regents any potential conflicts of interest involving the firm that is selected.

10. **ACADEMIC COUNCIL RESOLUTION ON INCLUDING PRIVATE EQUITY INVESTMENTS WITHIN THE 403(b) PLAN AND THE NEW 457(b) PLAN**

Faculty Representative Blumenthal recalled that at the March 31 meeting of the Academic Council, the University Committee on Faculty Welfare requested endorsement of its resolution on including private equity investments within the 403(b) plan and the proposed new 457(b) plan. The resolution is a result of concern that the University might remove these instruments from the 403(b) plan's equity options and not include them in the new 457(b) plan because of valuation issues that have been raised by the University's investment consultants. Currently, UC employees and retirees can invest in the equity fund of the 403(b) plan, which mirrors the stock holdings that the Treasurer chooses for the UCRP portfolio. As private equity has produced the highest rate of return over the past decade, it was the view of the Committee on Faculty Welfare, concurred with unanimously by the Academic Council, that UC employees and retirees should not be deprived of this investment opportunity.

Regent Parsky asked that the General Counsel review the language that is provided to employees and annuitants who invest in private equity to make sure that there is full disclosure about the nature of the investment, with a record for the file that he determined that this is the case.

Treasurer Russ commented that Orrick Harrington had been retained as an advisor on these issues.

The meeting adjourned at 3:50 p.m.

Attest:

Secretary