The Regents of the University of California

COMMITTEE ON INVESTMENTS
INVESTMENT ADVISORY COMMITTEE
November 14, 2005

The Committee on Investments and the Investment Advisory Committee met jointly by teleconference on the above date at the following locations: James E. West Alumni Center, Los Angeles campus; 111-A University Complex, San Diego campus; and 1111 Franklin Street, Room 5326, Oakland.

Members present: ***Representing the Committee on Investments***: Regents Dynes, Parsky, Pattiz, Preuss, and Rosenthal; Advisory members Oakley and Schreiner

Representing the Investment Advisory Committee: Regent Pattiz, Senior Vice President Mullinix representing President Dynes, Mr. Charles Martin; Consultants Behrle and Beim

In attendance: Secretary Trivette, Associate Secretary Shaw, General Counsel Holst, and Recording Secretary Nietfeld

The meeting convened in Regents Only Session at 1:30 p.m. with Chairman Parsky presiding.

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The Committees went into Closed Session at 1:45 p.m.

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The Committees went into Open Session at 2:30 p.m.

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. **PUBLIC COMMENT**

Chairman Parsky explained that the public comment period permitted members of the public an opportunity to address University-related matters. The following persons addressed the Committees concerning the items noted.

Item 601: Quarter and Fiscal Year Performance and Risk Report

A. Professor Emeritus Charles Schwartz proposed that the quarterly reports should contain data on assets held and performance for each individual external investment manager engaged by the University. The annual report should contain data on management fees paid to each external manager as well as a listing of commissions paid to all brokers. He believed that such information would have to be produced in response to a request under the California Public Records Act.

Item RE-63: Request for a Thorough Presentation on the Divestment of University Holdings in Four Foreign Companies Engaged in Substantial Business in Sudan and Thereby Assisting the Government of Sudan in its Genocidal Campaign in Western Darfur

B. Mr. Adam Sterling, a student at the Los Angeles campus and a member of the Sudan Divestment Task Force, expressed appreciation to Regent Rosenthal for placing the issue on the Committees' agenda. The task force represents a coalition of UC faculty, staff, students, and alumni who share the conviction that genocide represents the most heinous of crimes. The campaign for divestment has been joined by Stanford, Harvard, and Dartmouth Universities.

C. Mr. Don Cheadle, an actor and speaking also for Sheila Breeding, Matthew Sablove, and Karina Garcia, urged the Regents to consider the recommendation that University funds be divested from companies doing business in Sudan, noting that the Sudanese government's involvement with genocide in Darfur is ongoing. Having seen first-hand the results of these activities, Mr. Cheadle believed that there is no counter-argument to at least considering divestment.

D. Mr. David Attanasio, a student, reported that half of the population of Darfur relies upon humanitarian aid due to the systematic razing of villages and contamination of wells. He alleged that the Sudanese government's obstruction of this aid had caused between 5,000 and 10,000 deaths per month; the United States government has been largely ineffective in its opposition to genocide in Darfur.

E. Mr. Rohan Radhakrishna, from the UCSF-UCB joint medical program and speaking also for Tracy Shibata and Chason Smith, observed that divestment could serve as the needed leverage to influence the outcome in Sudan. The Sudanese government relies on direct foreign investment to raise revenue which disproportionately is used to fund the military. This reliance makes the government vulnerable to economic pressure. The task force's divestment proposal excludes businesses in Sudan that are involved in work that is humanitarian, social, educational, medical, or agricultural. UC divestment could raise national attention to the issue and add momentum for effecting change in Darfur.

F. Ms. Jenny Wood, president of the Associated Students at the Los Angeles campus, observed that UC's divestment would be a powerful step in ending the genocide in Darfur. Faculty, staff, and students across the campuses have signed an online petition in support of divestment.

G. Mr. Ben Elberger, a student at Stanford University and speaking also for Andy Green and Adam Greenwald, recalled that in March 2005 he and a fellow student had undertaken a divestment campaign that culminated in Stanford's board of trustees' decision to divest from PetroChina, Tatnef, ABB, Ltd., and Sinopec. He quoted briefly from Stanford President Hennessy, who noted that "divestment is an act that should be made rarely and carefully. In this case, it was clear that the genocide occurring in Darfur, which appears to be at least partly enabled by these four companies, is in direct opposition to Stanford University's principles." Mr. Elberger noted that Harvard University had divested more than $4 million in PetroChina stock; Dartmouth College has divested from six oil companies doing business in Sudan. Active divestment campaigns are under way at Brandeis, Brown, Yale, George Washington, Amherst, the University of North Carolina, the University of Virginia, the University of Washington, and Columbia.

H. Mr. Allen Roberts, a faculty member at the Los Angeles campus and speaking also for Katie Tokushige and Carel Ale, expressed his appreciation for the work of students who have shown an inspiring degree of commitment in pursuit of divestment from Sudan. He recalled that divestment had played a significant role in overcoming apartheid in South Africa.

I. Mr. Jason Miller, an M.D./Ph.D. candidate at the San Francisco campus and speaking also for Thomas Fonss and Danna Carmi, believed that the campaign for divestment from Sudan was unique due to the magnitude of the crime. A precedent has been set by peer institutions with which UC often compares itself, including Harvard and Stanford. He suggested that the proposal to divest would result in minimal harm to the endowment and would represent less risk than was taken during the divestment from South Africa. The Treasurer's Office has determined that the offending stock comprises 0.2 percent of the total endowment, all in foreign index funds.

J. Mr. Glynn Washington, executive director of the Council for Socially Responsible Investment, raised the issue of the appropriate fiduciary response to genocide. He believed that doing business with foreign companies investing in Sudan subjects the University to risk.

K. Ms. Tara Ramanathan, a student at the San Diego campus, recalled that The Regents had shown a commitment to social values when the decision was made to divest from

South Africa. She believed that divestment from companies doing business in Sudan would have a minimal financial impact on the University.

Secretary Trivette noted that a letter in support of divestment from Congresswoman Lee had been distributed to the Committees.

3. **APPROVAL OF MINUTES OF PREVIOUS MEETINGS**

Upon motion duly made and seconded, the minutes of the meetings of May 16 and August 16, 2005 were approved, Regents Dynes, Parsky, Pattiz, Preuss, and Rosenthal (5) voting "aye."[1]

4. **REQUEST FOR A THOROUGH PRESENTATION ON THE DIVESTMENT OF UNIVERSITY HOLDINGS IN FOUR FOREIGN COMPANIES ENGAGED IN SUBSTANTIAL BUSINESS IN SUDAN AND THEREBY ASSISTING THE GOVERNMENT OF SUDAN IN ITS GENOCIDAL CAMPAIGN IN WESTERN DARFUR**

Regent Rosenthal recommended that the Committee on Investments request that the President present to The Regents at the January 2006 meeting a comprehensive plan for the University of California Retirement Plan (UCRP) and the General Endowment Pool (GEP) to divest from the following foreign companies engaged in significant business relations with the government of Sudan: PetroChina, Sinopec, Tatnef, and ABB, Ltd. Regent Rosenthal further recommended that a policy of divestment from a foreign government shall be adopted by the University only when the United States government declares that a foreign regime is committing acts of genocide.

Regent Rosenthal observed that divestment is a serious decision that should rarely be pursued. He believed that the ongoing genocide in Sudan meets the appropriate standards for divestment; therefore, The Regents should consider a policy of divestment from the aforementioned companies in recognition of their ongoing business relations with the government of Sudan.

The Regents of the University of California serve as fiduciaries on behalf of the people of the State of California. In this capacity, The Regents has the responsibility of ensuring the financial success of the University's investments. The Regents entrusts the Treasurer to invest the UCRP and GEP in a manner pursuant to the primary investment goal of maximizing returns. In addition to the established pecuniary goals, The Regents has a proud history of recognizing the merits of socially responsible investing. For example, with respect to The Regents' investment policies, the Treasurer reserves the right to consider social issues

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

in proxy voting. Moreover, in its power and capacity as a shareholder, the University may conduct a case-by-case analysis of social matters as they relate to University holdings. Along with the Treasurer, The Regents has also directly made investment and divestment decisions based on concerns of social justice and human rights.

For example, in 1986 The Regents voted to divest holdings from South Africa in protest of the government's policy of apartheid. In 2001, The Regents directed the Treasurer to continue the practice of not directly investing in tobacco products companies during the transfer of a portion of the equity holdings to index funds. While The Regents has been presented with numerous divestment proposals over the past two decades, the Board has made it clear that a policy of divestment will be pursued only in reaction to the most repugnant governmental policies and industry practices. Up to this point, The Regents has yet to articulate clearly the circumstances under which the University will undertake a divestment policy.

Regent Rosenthal suggested that the time has come for The Regents to declare publicly that it is not financially or socially acceptable to continue to support the Sudanese regime via foreign investment. If The Regents choose to maintain the status quo, the University will continue to profit from foreign companies that are helping to fund the government of Sudan's genocide campaigns in Darfur. The Regents may decide that the time has come to divest the University from several companies that have financially supported the Sudanese government's campaign of mass murder. In choosing the latter option, the University will join Stanford and Harvard Universities, as well as the Illinois, New Jersey, and Oregon legislatures, in sending a clear message that the University of California has no desire to profit from companies that are closely aligned with the government of Sudan's invidious practices.

Regent Rosenthal reported that in 1956, Sudan, which is the largest country in Africa, became a sovereign nation. Since then, it has had two civil wars, the most recent ending in January 2005. The peace treaty ending this war did not address the genocide in Darfur. While it is difficult to determine the precise number of casualties, the U.S. State Department has estimated that 160,000 Darfurians have been murdered since February 2003; the Coalition for International Justice puts the number at 400,000. The United States government has been sparing in its use of the term "genocide" over the past century. When President George W. Bush and Secretary of State Colin Powell stated that the Sudanese government was committing acts of genocide, it was the first time that the U.S. has declared an instance of genocide while it was ongoing. The state legislatures of Illinois, New Jersey, and Oregon have passed legislation mandating the divestment of state funds from foreign companies doing business in Sudan. A growing number of educational institutions across the country have divested or are considering divestment from selected companies operating in Sudan. Stanford University's targeted divestment differentiates between those companies that engage in revenue enhancement for the Sudanese government and those that provide products or services to the government of Sudan. The four companies selected for divestment are revenue-enhancement corporations.

Regent Rosenthal believed that the proposed divestment would send a strong message to the targeted companies that the University will no long provide them with capital if they continue to support the Sudanese government's genocidal campaign. He suggested that, if The Regents decides to divest, other universities would follow suit. The University follows the prudent investor rule; he believed that a policy of divestment from Sudan would be in accordance with this investment philosophy. Any index which contains one of the four companies may be replaced by another company of similar size and market share. Modern portfolio theory holds that if the money invested in the named companies is transferred to other holdings with similar expected returns, The Regents' portfolio will not be adversely affected. The Regents should be concerned that investing in companies that do substantial business in Sudan presents a financial risk.

Regent Pattiz commented that the recommendation was a reasonable one which would provide the Board of Regents with an opportunity to determine which course to pursue with respect to divestment from Sudan.

President Dynes observed that, during the process of performing due diligence, it is possible that the four companies named in the recommendation may not be the only ones from which the University may wish to divest. He was inclined to request an analysis of the fiduciary impact of such a divestment policy. Regent Rosenthal confirmed that his recommendation was focused on four companies doing substantial business with the Government of Sudan.

Following further comments from President Dynes, Chairman Parsky noted that Regent Rosenthal has requested that there be presented at the January 2006 meeting a specific plan for divestment from four companies doing business in Sudan. In addition, a policy on divestment should be adopted. In order for the Regents to be fully informed, there will need to be a recitation of comparable policies that have been adopted by peer institutions. This should include what directions have been given to internal and external portfolio managers. Regent Rosenthal confirmed for Chairman Parsky that a discussion of a policy of divestment would be triggered only when the United States government has issued a finding of genocide in another nation.

Regent Pattiz assumed that consideration would be given to what steps would be taken if genocide were to end in Sudan. Regent Rosenthal noted that the University had resumed investment in companies doing business in South Africa following the end of apartheid.

Upon motion duly made and seconded, the Committee approved the recommendation and voted to present it to the Board, Regents Dynes, Parsky, Pattiz, Preuss, and Rosenthal (5) voting "aye."[1]

5. **TREASURER'S ANNUAL REPORT, 2004-05**

The Interim Treasurer recommended that the Committee forward to The Regents the Treasurer's Annual Report for the fiscal year ended June 30, 2005.

[The report was mailed to all Regents in advance of the meeting, and a copy is on file in the Office of the Secretary.]

It was recalled that the Bylaws state that the Committee on Investments will report periodically to the Board concerning the investment operations of the University. The Treasurer's Annual Report goes into detail concerning these operations.

Upon motion duly made and seconded, the Committee approved the Interim Treasurer's recommendation and voted to present it to the Board, Regents Dynes, Parsky, Pattiz, Preuss, and Rosenthal (5) voting "aye."[1]

6. **QUARTER AND FISCAL YEAR PERFORMANCE AND RISK REPORT**

Interim Treasurer Berggren reported that the investment performance for the University of California Retirement Plan (UCRP), the General Endowment Pool (GEP), and the Short Term Investment Pool (STIP) for the quarter ended September 30, 2005 was positive on both an absolute and relative basis. The UCRP returned 2.86 percent for the quarter, for an active return of 21 basis points. The major contributors to the performance were U.S. equity and fixed income. Ms. Berggren outlined the performance objectives for the UCRP, noting that the annualized total return (net of all fees and expenses) was 14.46 percent over the past three years and 3.11 percent over the past five years, in comparison to the Plan's actuarial rate of return of 7.5 percent. The funded ratio is positive at 109 percent as of September 30, 2005 based on actuarial value and 112 percent based on market value. The total return for the three-year period exceeded the Consumer Price Index by 3.17 percent. She reported that all of the asset classes were in the policy range for the quarter. Interim Treasurer Berggren noted that risk had been reduced from a high level to a more neutral level through diversification of the portfolio.

In response to a question from Chairman Parsky, Ms. Berggren reported that 66 percent of the portfolio is invested passively. The process for the selection of external managers involves the selection by staff in the Treasurer's Office of a universe of managers to evaluate. Mr. Tom Richards of Richards and Tierney, The Regents' investment consultant, continued that his firm performs due diligence, the results of which are shared with the staff. There have been no disagreements, although some managers have been terminated due to changes in the organizations.

Interim Treasurer Berggren discussed the bond portfolio characteristics, noting that the average duration is 7.6 years and the average quality is AA. Security selection has been consistently superior over time. Private equity investments have provided excellent returns. Ms. Berggren commented on the market value changes for the quarter, noting that $1.2 billion had been added to the portfolio.

In response to a question from Chairman Parsky, Ms. Berggren responded that the area of the portfolio that poses the most concern is emerging markets, which may not continue to perform as well as in the past. The other area is the small cap portfolio, which also has had excellent performance. Chairman Parsky asked about the allocation to Absolute Return. Interim Treasurer Berggren reported that 10 percent of the GEP is invested is this asset class, representing $500 million in commitments. The focus is on long-term managers with good returns. The consultant for the AR asset class is Albourne Partners. The firm is highly focused on risk management, and it has a wide universe of hedge funds that it evaluates regularly. The majority of the managers have had positive returns. There is no commitment to Absolute Return within the UCRP. Chairman Parsky saw a need for caution in terms of the capability of the staff to implement the program. If more outside advice is required, it should be sought.

Mr. Martin agreed with Chairman Parsky's position, noting that the hedge fund industry is in transition. He supported the concept of outside expertise in this area.

Regent Parsky asked that the next report break out the $500 million that is invested in Absolute Return and indicate performance. Mr. Martin added that would be important to understand the strategy being employed for investments in this asset class. Ms. Berggren commented that the overall strategy had always been narrow, with attention to the diversification of the portfolio. There has been an 8 percent return on investment since the inception of the program in April 2003; for the calendar year to date, the return was 4.5 percent. The benchmark for Absolute Return is cash.

Regent Parsky suggested that the Interim Treasurer give some consideration to how the Regents should view the overall allocation of this money and what benchmark of returns should be used. Ms. Berggren confirmed that the funds used for investing in Absolute Return were transferred from fixed income. In response to further comments by Regent Parsky, Ms. Berggen stressed that the objective of investing in Absolute Return had been to increase the diversification of the portfolio, which enhances the overall return. Regent Parsky emphasized the need to assess what to part of the portfolio this asset class is an alternative. Senior Vice President Mullinix suggested that it most resembles fixed income. The concept of Absolute Return is that it is almost risk free.

Mr. Richards observed that there are two types of investment risks – market risk and active management. Because the AR asset class is a cash-oriented type of investment, the risk in this case comes from the management.

Chairman Parsky suggested that the consultant for Absolute Return be invited to attend a future meeting.

7. **FIXED INCOME OVERVIEW**

This presentation was deferred to a future meeting.

8. **UCLA FOUNDATION ASSET ALLOCATION**

Chairman Parsky invited the representatives of the UCLA Foundation to the table for their presentation. Mr. Tim McCarthy, a director of the foundation, introduced his colleagues Mr. Herbert Kawahara, the chair of the foundation, and Mr. Peter Taylor, the immediate past chair of the foundation and a former Regent. Also present was Assistant Vice Chancellor Neal Axelrod and Ms. Rebecca Gratsinger, the president of R.V. Kuhns & Associates, a consultant to the foundation.

Mr. McCarthy recalled that when he joined the foundation approximately ten years ago, it had no investments other than traditional securities. Since that time, there has been a significant change. Development of the alternative asset program began in fall 2000 when the investment committee resolved to implement an investment allocation strategy that would provide broader diversification, equal or lower portfolio risk, an annual return of 5 percent above inflation, and reduced exposure to U.S. equity markets. Mr. McCarthy explained that the UCLA Foundation asset allocation transition plan is now in the third of six phases. This phased approach was selected to provide adequate time to evaluate, select, and fund new managers, to avoid investment concentration in a limited set of vintage years, to set interim target asset allocations during the transition to ensure that acceptable levels of return and risk are maintained during the transition, and to provide higher risk-adjusted returns during each phase of the transition. The foundation has endeavored to keep the Treasurer and the Chair of the Committee on Investments/Investment Advisory Committee updated on asset allocation planning and the progress toward targets.

Mr. McCarthy reported that, in reviewing peer performance for the asset allocation analyses, it became apparent that colleges and universities with larger alternative allocations produced significantly higher returns with lower volatility. Those institutions with Absolute Return over 20 percent outperformed the UCLA Foundation. The difference between these returns would have added about $46 million to the foundation's endowment over a five-year period, resulting in a higher pay-out to the campus. The increased focus on alternative investments has resulted in improved relative and absolute returns for the foundation. The UCLA investment committee and its board of directors believe that the foundation is on the right course and would like to continue to pursue these targeted allocations. Applying the Treasurer's 2005 capital market assumptions to the foundation policy asset allocation yields a break-even return versus pay-out and inflation. A reduction in that return would likely result in a reduction in pay-out for endowment fund beneficiaries. Mr. McCarthy discussed what the effect on the performance would be if alternative investments were limited to 40 percent, noting that it would concentrate risk exposure particularly to U.S. markets. The foundation recently became aware of the amendments to the investment policy for the General Endowment Pool that were adopted by The Regents in September 2005. These amendments included a reduction in the allocation to alternative investments from 40 percent to 30 percent. The detrimental effect on the foundation's assets would be exacerbated at this lower level.

Mr. McCarthy provided a list of the diversification in the Absolute Return asset class, which is invested in three ways: with The Regents, by direct investments, and through fund of funds. As of the last quarter, the foundation had $111 million invested in Absolute Return, with an average manager exposure of $1 million.

In concluding his remarks, Mr. McCarthy noted that the UCLA Foundation believes that its investment policy statement and phased implementation of an appropriate asset allocation is prudent and in accordance with its mission to support UCLA.

Regent Parsky noted that the role of The Regents with respect to the campus foundations is general oversight. Within that function, the Board is responsible for reviewing the performance of the foundations' portfolios. In carrying out that role, The Regents sets asset allocation ranges for the portfolio that is overseen by the Treasurer's Office; these guidelines are provided to the foundations. If a foundation wishes to vary from those guidelines with respect to any asset class, justification should be provided for why it is doing so. He asked Mr. McCarthy to summarize the UCLA Foundation's request.

Mr. McCarthy recalled that in May 2005 the projection had been made that the foundation's allocation to alternative assets would reach 40 percent in the calendar year, and that will occur. When the foundation learned of the amendment to the Investment Policy Statement for the GEP limiting alternative investments to 30 percent, the foundation's allocation was well past 30 percent. Marketable alternative investments include Absolute Return strategies, real estate, timber, energy, and private equity. The foundation is contemplating an asset allocation of 52 percent to these combined categories.

Interim Treasurer Berggren reported that she had met with the UCLA Foundation and reviewed the asset allocation plan. At the meeting, she had commented on the popularity of alternative investments. She believed that the strategy described by Mr. McCarthy represents a higher level of risk than that of the GEP, although it is consistent with other foundations.

Mr. Martin supported the higher commitment to alternative strategies but noted that these categories require a great deal of expertise in evaluating managers, as well as access to top managers. He asked Mr. McCarthy to comment on the background and experience of the foundation's investment staff. Mr. McCarthy explained that the foundation has limited investment staff, which is why its funds are managed externally. In terms of the due diligence process, 80 percent of the investments in Absolute Return are either co-investments with The Regents or in funds of funds. The increased complexity of the portfolio has resulted in the formation of specialized subgroups, as well as additional staff. Mr. Taylor added that the volunteers are heavily engaged in the process.

In response to a question from Regent Parsky regarding the process used to invest in these funds, Ms. Gratsinger noted that her investment manager research uses the tools in the marketplace. The funds of funds that have been added to the program will serve as the basis for diversification in both the Absolute Return and private equity areas.

Regent Parsky observed that there should be a recommendation from the Treasurer's Office with respect to the appropriateness of the foundation's proposed asset allocation. There should be a description of how the program will be implemented. He did not see any reason The Regents would object to the foundation's investment program.

The meeting adjourned at 4:25 p.m.

Attest:

Associate Secretary