The Regents of the University of California

COMMITTEE ON INVESTMENTS
INVESTMENT ADVISORY COMMITTEE
March 6, 2007

The Committee on Investments and the Investment Advisory Committee met jointly by teleconference on the above date at the following locations: Covel Commons, Los Angeles Campus; UCSF-Mission Bay Community Center, 1675 Owens Street, San Francisco; 401 B Street, Suite 1200, San Diego.

Members present: ***Representing the Committee on Investments:*** Regents De La Peña, Schilling, Schreiner, and Wachter

Representing the Investment Advisory Committee: Mr. David Fisher and Mr. Chuck Martin; Consultants Behrle, Child, and Lehmann

In attendance: Regent Ledesma, Regent-designate Allen, Acting Secretary Shaw, General Counsel Robinson, Chief Investment Officer Berggren, and Recording Secretary Smith

Due to the lack of a quorum, the meeting was held as a briefing session for the members. All recommendations will be submitted for action at the next meeting of the Committee on Investments.

The meeting convened at 1:40 p.m. with Regent De La Peña 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' agendas.

2. **PUBLIC COMMENT**

Regent De La Peña 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 I6, Status of Divestment from Sudan

A. Mr. Jason Miller, previous co-chair of the UC Divestment Task Force, reported that since UC made the decision to divest from Sudan in March 2006, the State of California and many city pension funds in California have adopted a similar model of divestment, and other states and countries are likely to follow.

Mr. Miller asked that the assets be sold off before the end of the 18-month time window, consistent with prudent investor obligations. He also encouraged continued follow-up with the three companies with which UC is currently engaged regarding improvement in governance plans in Sudan.

B. Ms. Katrina Garcia, member of the Darfur Action Committee at UCLA, explained that Assembly Bill 2179 was unanimously passed and signed by the Governor, in large part due to the lobbying efforts of UC students, giving UC the needed legal protection for divestment. She asked that the UC Treasurer's Office implement full and expedited divestment, and requested that students be provided with full disclosure to whatever degree possible.

University-related Issues

C. Mr. Jared Fox, previous President of the Graduate Student Association at UCLA, stressed the importance of attracting high-quality graduate students to the University in order to recruit and retain top faculty and receive grants. Mr. Fox stated that high fees discourage students from entering public service positions due to the amount of debt accrued, the lack of adequate loan-forgiveness programs for public policy, and insufficient loan-forgiveness programs for law schools. He stressed the need for loan forgiveness programs for public interest work.

D. Mr. Charles Schwartz, Professor Emeritus from Berkeley, noted that the Committee had not met for six months despite the fiduciary oversight requirement to review fund performance quarterly. Performance data obtained from State Street showed that over the previous six-month period 61 percent of UC's external investment managers failed to meet their assigned benchmarks on the return on investments. The investment performance of UCRP compared with peer institutions has fallen below the mean of large comparison groups, and was five percentage points below that of CALPERS and six percentage points below that of CalSTIRS.

(At this point, Committee Chair Wachter assumed the Chair.)

3. QUARTERLY INVESTMENT PERFORMANCE SUMMARY

Chief Investment Officer Berggren reported that the University of California Retirement Plan (UCRP) and General Endowment Pool (GEP) had positive returns for the quarter, the fiscal year to date, and the latest 12-month period. The UCRP generated 6.13 percent return for the quarter, a 10.74 return in the fiscal year to date, and 13.02 for the latest 12 months. This was modestly below the benchmark, 10 basis points for the quarter, 10 basis points in the fiscal year to date, and 34 basis points in the latest 12 months. The GEP return was 6.4 percent for the quarter, 10.56 percent for the fiscal year to date, and 14.98 for the latest 12 months, for a positive variance of 27 basis points, 32 basis points, and 44 basis points respectively above the benchmark. The better performance of the GEP reflects the positive impact of Absolute Returns in the asset mix.

Ms. Berggren reported that the underperformance of the UCRP fund is due to the underperformance of the US equity market during all time periods. The Treasurer's Office has implemented changes in personnel and is revising the strategy to address these problems. The underperformance is almost entirely due to security selection. A slight tilt to growth and small-caps has negatively impacted performance; however, the US equities did have positive absolute performance for the quarter. The non-US developed and emerging markets areas were also quite strong, a trend seen almost every quarter in the previous year. Fixed Income performed well in all periods. Bonds benefited from the fact that world economic growth was good, inflation was controlled, liquidity was good, defaults were few, and monetary policy was accommodating.

In terms of performance objectives for the UCRP, all asset classes were within policy guidance ranges. The biggest factor bets were an underweighting in credit, high-yield, large-value, and mid-growth sectors, and the biggest contributors to risk were an underweighting in large-value and mid-growth. The bond portfolio had a duration that was slightly less than the benchmark, and an average quality that was slightly higher than policy. The largest contributors to performance were the underweight in government bonds and an overweight in corporate bonds. In an analysis of style exposures, the US equity portfolio indicates a portfolio with more earnings variability, more growth, more trading activity, more volatility, smaller size, and less yield.

In response to a question by Mr. Fisher, Ms. Berggren explained that the performance of the UCRP was due to the trend over the last 15 months of fund managers to buy small-cap stocks. In response, every quarter the Treasurer's Office reviews the strategies of fund managers and rearranges holdings if the orientation of the fund managers does not meet investment goals.

Mr. Martin commented that a comparison between the performance of the UCRP and the GEP must take into account that the Fixed Income component is much higher in the UCRP than in the GEP – 27 percent compared with 21 percent, respectively. Mr. Lehmann noted that even 21 percent might be too high for an endowment portfolio.

Ms. Berggren further reported a negative bias toward energy and financial stocks and a positive bias toward technology in the UCRP. An analysis of the non-US portfolio indicates that the most active risk exposures are in the sector and currency factors. The regional exposure has an overweight in Europe, a slight overweight in emerging Asia, and an underweight in Canada. The largest underweights in the sector exposure are energy and financial stocks.

Mr. Lehmann commented that this is the closest the portfolio has ever come to being neutral to Japan. Ms. Berggren explained that staff has been added in the international area. In response to a comment by Mr. Fisher regarding the potential of international exposure, Ms. Berggren emphasized that the European markets look very attractive right now.

In an analysis of Private Equity performance, the UCRP outperformed the benchmark, with an excess return of 10.8 percent for a multiple of 2.3, and the total return of the portfolio has been 22.36 percent for the last 10 years, significantly above the benchmark. This is likely the best performance of any fund of funds in the country. In response to Committee Chair Wachter's question, Ms. Berggren explained that the benchmark was the Cambridge Private Equity.

Mr. Lehmann pointed out that two percent of the Private Equity portfolio is generating eight percent of the total return for the UCRP. Ms. Berggren observed that since inception the Private Equity portfolio has had only one underperforming fund, and overall has had an extraordinarily good selection. The buyout area has contributed to performance.

Ms. Berggren turned to the performance of the GEP fund. As mentioned, the GEP has outperformed the benchmark in all time periods. The keys to this performance relative to the benchmark were good performance in the areas of Fixed Income and Absolute Return. Contributing to the 27 basis points of active return in the quarter, 26 percent comes from Absolute Return security selection. Overall in the GEP, asset allocation and security selection accounted for approximately 14 basis points of the excess return. All of the asset classes were within policy guidelines. Factor analysis indicates that the major contributors to the performance were the overweight in credit and underweight in high-yield, large-value, large-growth, and mid-growth. The biggest contributors to risk were the underweight in large-value, large-growth, and mid-growth. In response to comments by Mr. Lehmann and Mr. Fisher, Ms. Berggren agreed that diversification and the experience of the Treasurer's Office in manager selection have carried over into the Absolute Return area. The portfolio added $3.6 billion of value in the quarter, and roughly $5 billion for the year.

In response to an inquiry by Committee Chair Wachter, Ms. Berggren commented that the underperformance in equities was the result of too much orientation toward stock selection in the portfolio and a small-cap orientation. The Treasurer's Office has moved some assets from small-cap Russell to large-cap Russell, which has benefited the portfolio in the most recent market decline. A systematic, strategic view of the portfolio is underway, reducing managers that have not provided the necessary value added. By the end of March, the Treasurer's Office will analyze manager run-down and weights, and will review these changes with the Chairman at that time.

Mr. Richards of Richards & Tierney noted that this year was very difficult for active managers, in that as many as 90 percent of active managers in the domestic equity arena underperformed their benchmarks. Committee Chair Wachter believed that such a situation is a reason for indexing. Ms. Berggren responded that the portfolio is 45 percent indexed, and that the Treasurer's Office is moving from small-cap to large-cap and rearranging the roster of managers and strategy.

4. **ASSET ALLOCATION REVIEW AND RECOMMENDATIONS**

The Chief Investment Officer (CIO) recommended, and Richards & Tierney concurred, that the attached Asset Allocation, Rebalancing Policy, and Benchmarks for the University of California Retirement Plan (UCRP) and the University of California General Endowment Pool (GEP) be approved, effective July 1, 2007.

It was recalled that following the adoption of a new Investment Policy Statement for the UCRP in 2004 and GEP in 2005, the Office of the Treasurer conducts an annual review of asset allocation and investment policy each spring. The purpose of this review is to update the capital market assumptions used in asset allocation, and to recommend any changes to the asset allocation which would better achieve the return and risk objectives of the Funds.

The CIO proposed to continue to increase the allocation to alternatives, but at a measured pace, recognizing the large flows of capital into this area. Realistic targets are proposed for the weights of Private Equity, Real Estate, and Absolute Return strategies over the next 12 months. In addition, long-term asset class target weights are presented for all asset classes.

The principal changes proposed herein are an expansion of the allocation to Absolute Return strategies in the GEP from 15 percent to 20 percent, and an introduction of a small allocation to Absolute Return strategies in the UCRP, initially set at 0.5 percent. No changes to asset class benchmarks are proposed.

At the request of the Committee, this proposal modifies the existing rebalancing policy as follows. The combined asset group ranges are reduced from ± 15 percent to ± 7 percent around combined equity and ± 5 percent around combined bonds and alternatives. In addition, ranges are set for individual asset classes. The US Equity weight must be within ± 5 percent of target; all other asset classes must be within ± 3 percent of target. These ranges were chosen to be consistent with Regents' investment policy: the Committee approves asset allocation while the CIO implements policy. The sizes of the bands are based on the size and volatility of each target. This proposal is applicable to the UCRP and GEP.

Chief Investment Officer Berggren reported that the Treasurer's Office continues to believe that the Absolute Return asset class provides diversification and a defensive element to the portfolio. It is recommended that within the UCRP an Absolute Return strategy allocation be established of 50 basis points near-term and five percent long-term. An increase in the long-term policy and weights for both Private Equity and Real Estate is also proposed. It is recommended that Private Equity increase from two percent to three percent near-term and five percent long-term, and Real Estate increase to three percent near-term and five percent long-term. Currently this asset class holds $436 million.

Committee Chair Wachter noted that many other pension funds have significantly higher targets than the ones proposed, and that the GEP targets and the Foundations' targets are also higher. He questioned whether these are the appropriate targets or if more money should be allocated to these asset classes. He stated that these markets will likely provide a good return, somewhere in the mid-teens.

Mr. Martin responded that CALPERS' Private Equity exposure is almost entirely in the buyout arena. It is not true that other pension funds have as much diversified exposure to asset classes in comparison with the proposal. Mr. Martin agreed that UCRP could move faster to higher allocations, but expressed caution regarding the difficulty of intelligently deploying capital into these asset classes.

Ms. Berggren explained that long-term targets are set for small-, mid-, large-, and mega-buyouts and ventures. In the last year the Treasurer's Office has become confident about certain managers, and in such cases increased its commitment to as much as $200 million. Ms. Berggren also cautioned that these markets are becoming very tight, and expressed her concern about the large amount of money entering these asset classes at present. The Treasurer's Office is focusing on the distressed area.

Mr. Martin stressed the importance of time diversification in the long-term asset classes as a way to manage risk.

Mr. Fisher supported the long-term objectives proposed, particularly given that the targets will be revisited, and agreed on the importance of investing over time as a risk-reducing strategy. He emphasized that holding a diversified set of asset classes is a powerful way to manage risk, and that Absolute Returns, Private Equity, and Real Estate are categories that will provide such diversification. He would support moving faster if Ms. Berggren feels it appropriate. Mr. Lehmann agreed that these are diversifying asset classes.

Committee Chair Wachter continued to assert that his main concern is making more money for the beneficiaries of the pension fund. Given that Absolute Return, Private Equity, and Real Estate are very good bets over the long-term, he questioned why more money would not be allocated to these areas.

Mr. Richards discussed the process that underlies the work with respect to the expected returns in the asset classes and expected risk, including sanity checks with other experts throughout the institutional investment community. The result of the process is an efficient portfolio with a level of risk that is consistent with what has been in the past.

Mr. Phillips, Managing Director of Investments, explained how the Treasurer's Office measures risk. The primary way risk is conceived is in terms of losing money, the statistical measure of which the Treasurer's Office uses for Absolute Returns, Private Equity, and Real Estate due to the unique characteristics of these asset classes. Manager selection is essential in these asset classes. In the publicly traded asset classes, volatility is used as a risk measure due to its long history and robustness. There is a clear relationship between volatility and the possibility of losing money. Risk is measured to understand where it is being taken, not in order to eliminate or reduce it.

Mr. Richards commented that the focus on bonds is coming primarily from private funds. The theme is Liability-Driven Investing (LDI) in order to manage interest rate risk and at the same time maintain some exposure to equity-type returns.

Ms. Berggren described the proposed asset allocations for the UCRP. She stated that the Treasurer's Office has reduced and diversified the Fixed Income category. Mr. Martin questioned the goal of having 27 percent in Fixed Income. In response to a question from Committee Chair Wachter, Ms. Berggren responded that the allocation is defensive and suits the risk tolerance of the pension fund. Mr. Martin asked if there were better ways to diversify and lower risk exposure than Fixed Income. Ms. Berggren explained how the overall asset allocation was developed. There are specific overall assumptions for each asset class, taking into consideration volatility and correlation. It is important to look at all asset classes together, optimize them, and then ensure that the overall allocation meets the criteria for risk, with the goal of maximizing returns given the level of risk in relation to other public institutions. Ms. Berggren stressed that the retirement plan involves a fiduciary responsibility, requiring that it be managed differently from an endowment fund.

Mr. Fisher suggested that the returns would be higher if a larger percentage of the fund were invested internationally.

Ms. Berggren stated that the Treasurer's Office would take back the input from the discussion, reassess the allocations, and return to the Committee for further discussion. Mr. Fisher encouraged the Treasurer's Office to look at the All Country World Index, given that over the next twenty years developing countries are likely to provide good returns. Committee Chair Wachter suggested that allocations in emerging markets such as India and China might be too low. Ms. Berggren stated that at the next meeting they will come back with a recommendation for a European strategy piece and increasing international allocation. Regent Schilling inquired about Private Equity in Asia. Ms.

Berggren stated that the Treasurer's Office is bringing on a new director of Private Equity, with the intention of doing the same work on Asia that staff have done on Europe.

Ms. Berggren explained the proposed asset allocations for GEP. The recommendation is to increase the Absolute Return allocation to 20 percent. Mr. Martin expressed his approval of the GEP allocation mix. Committee Chair Wachner asked if it were appropriate that the UCRP and GEP should have drastically different asset allocations. Mr. Lehmann stated that the UCRP and GEP are very different and that, considering the fiduciary responsibility of the retirement portfolio, due diligence is essential for the UCRP.

5. **ADOPTION OF EXPENDITURE RATE FOR THE GENERAL ENDOWMENT POOL**

The President recommended that the expenditure rate per unit of the General Endowment Pool (GEP) for expenditure in FY 2007-08 shall remain at a rate of 4.75 percent of a 60-month moving average of the market value of a unit invested in the GEP.

University Counsel O'Neill recalled that the President, in consultation with the Chief Investment Officer, recommended that the expenditure rate per unit of the GEP for eligible funds in FY 2006-07 be a rate of 4.75 percent of a 60-month moving average of the market value of a unit invested in the GEP. The payout would be distributed in August 2007 for expenditure in FY 2007-08. This would maintain the rate adopted by The Regents in March 2006 for expenditure in FY 2006-07.

At its March 2006 meeting, the Committee on Investments also approved a proposal to maintain the endowment cost recovery rate of 25 basis points (0.25 percent). Endowment cost recovery is taken from the endowment payout each year and is used to recover a portion of the costs of administering and carrying out the terms of the endowments on the campuses and at the systemwide offices. The funds released by this mechanism will be used by the campuses to help support additional fundraising expenses.

In October 1998 following a study, The Regents 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. In the interim years, the payout rate has been increased in stages to 4.75 percent for expenditure in 2006-07.

The Treasurer's Office provided estimates, in dollar terms and year-to-year percentage change of GEP, for payouts based on a range of assumed GEP investment returns through the end of FY 2006-07, the end of the 60-month averaging period. This range of dollar payouts is considered to be an appropriate balance among the following objectives that were discussed with The Regents in October 1998:

A. Maximize long-term total return.

B. Preserve the real (i.e., after inflation) long-term purchasing power of the endowment portfolio's principal and of its distributions.

C. Optimize annual distributions from the endowment portfolio.

D. Maximize the stability and predictability of distributions.

E. Promote accountability of asset management (disclosures to donors, performance reporting, etc.).

F. Promote the fundraising effort.

In response to a question from Regent Schilling, Mr. O'Neill affirmed that the endowment cost recovery is taken out of the payout, making it one quarter of one percent of the 4.75 percent.

6. **ADOPTION OF ENDOWMENT ADMINISTRATION COST RECOVERY RATE**

The President recommended that an endowment administration cost recovery rate of 25 basis points (0.25 percent) be approved to apply to the distributions from the General Endowment Pool (GEP) to be made after July 1, 2007, from the eligible assets invested in the GEP to defray, in part, the cost of administering and carrying out the terms of endowments on the campuses and at the systemwide offices.

It was proposed that the endowment administration cost recovery rate be set at 25 basis points (0.25 percent), the same rate approved in 2006. The funds so recovered would help to defray the costs on the campuses and at the systemwide offices of administering and carrying out the terms of the endowments. The funds released by this mechanism would be used by the campuses to increase campus fundraising efforts.

University Counsel O'Neill recalled that, following an analysis of costs to administer and carry out the terms of endowments on the campuses, The Regents, at the October 1998 meeting, adopted an endowment administration cost recovery rate of 15 basis points (0.15 percent) applied to the eligible GEP distributions made after July 1, 1998. The recommendation was made pursuant to the March 1998 action of The Regents, in which the endowment administration cost recovery policy was adopted, as permitted by California trust law, to allow the recovery from the endowment payout of reasonable and actual administrative costs for gift assets invested in the GEP. Such costs include compliance with gift terms, reporting, and other related activities necessary to carry out the terms of endowments at the campuses and the Office of the President. The endowment administration cost recovery rate was increased to 25 basis points (0.25 percent) in 2006.

The legal justification for the endowment administration cost recovery policy is a December 1996 opinion from the California Attorney General, in which he stated, “Probate Code section 15684 specifically authorizes the reimbursement for all costs properly incurred in the administration of (endowment) funds. All such reimbursements must, however, come from income and not from principal (Probate Code section 16312).” In addition, he said, “all such expenses must be properly documented and accounted for and reimbursements subjected to independent audits. To the extent the University has pooled funds and incurs expenses on a pooled basis, it may allocate such expenses among the (endowment) on a proportionate basis.”

Since the initial endowment cost recovery study in 1998, further analyses have shown that substantially greater costs were incurred in endowment administration. The actual cost in dollars to administer endowments has been reported by the campuses to be over $36 million, including both Regents and Foundation endowments. Expressed as a percentage of the 60-month average endowment value, it is approximately 57 basis points (0.57 percent). Thus, the current rate of 25 basis points (0.25 percent) will recover just under approximately one-half of the actual costs at the campuses and the systemwide offices to administer Regents endowments.

The funds recovered in this fashion provide the campuses with a source from which endowment administration costs will be paid and will have the effect of releasing the funds currently used to cover endowment administration expenses. The President and the Chancellors have committed to use the funds released by this fund source for incremental fundraising support to enable campuses to enhance their fundraising activities, not as an offset of existing fundraising expenses. The cost recovery program will be reviewed regularly by the Office of the President, as will the impact of the additional funds released for fundraising activities.

Each campus and the Office of the President are permitted to recover endowment-related expenses of 25 basis points (0.25 percent) to be taken from the payout. The balance of each year’s payout would support the individual endowments’ related program activities.

The Office of the President, in association with the campuses, will continue to review whether it is advisable to recover a greater percentage of the actual costs of endowment administration, perhaps up to the systemwide aggregate average for the costs of endowment administration.

Regent Schilling inquired as to why, if 0.25 percent only covers half of the actual costs, 0.50 percent is not recommended. Mr. O’Neill explained that when individual funds were analyzed in the GEP, most were not obtaining the 5.5 percent increase from year to year. The 5.5 percent is a macro-view that takes into account new funds that have come into the GEP over the last few years. An increase in cost recovery would have a detrimental impact on those existing funds, and over the past few years, those funds have been relatively flat. The Treasurer's Office is exploring other ways to recover those endowment costs. Regent Schilling asserted the importance of paying the actual costs of the fundraising, as fundraising departments are being relied upon more and more to contribute to UC's budget. Mr. Lehmann explained that this is an allocated overhead problem where fundraising costs are being allocated to existing funds as well as to new funds. Mr. O'Neill explained that the Treasurer's Office is exploring a number of alternatives not only to help recover the endowment administrative costs but also to pay for the central fundraising expenses.

Mr. Behrle asked about the rationale for taking money from one donor that has created an endowed fund in order to raise future gifts. Mr. O'Neill explained that it is a two-step process. The campuses are incurring certain costs in administering these funds, and the endowment cost recovery is designed to recover those costs. However, when the Regents adopted cost recovery in 1998, each of the Chancellors committed to use a similar fund source for fundraising efforts. Because the endowment was covering its own administrative expenses, there was not the need to use these other funds that had been used to cover those expenses prior to that time. It is the freed-up funds that the campuses are committing to use for development.

7. **INVESTING IN COMMODITIES**

Director of Real Assets Gil gave a presentation on commodities, including the methods for gaining exposure and the potential benefits. Commodities are raw materials to feed, to build, or to generate power, including raw materials used to create food, precious and industrial metals, and gas and oil. There are hard and soft commodities, perishables and non-perishables.

There are four methods to gain exposure to commodities. The first method is direct physical investment, but this option is not practical. The second method, a portfolio of commodity-related stocks, has potential because it is liquid and transparent, and would allow exposure to where there is no futures market. This method may not necessarily be diversifying as it is related to the equities market, although some exposure would provide diversification. The third method is private investment in Direct Equity or Private Equity funds such as energy production, timber, and paper products. These funds may hedge to limit price changes and lock in long-term contracts. Fourth, the preferred method for initial allocation, is commodity futures, which is an obligation to buy or sell a specific commodity at a fixed price. The three sources of returns for this method are the change in spot price, the collateral yield or interest earned on Treasury Bills, and the roll yield or the difference between the current price and the price of a futures contract. This method would provide a pure play exposure to commodities only.

Methods to gain exposure to commodity futures include a pure passive strategy, which is following the index, and could be executed with separate or commingled funds. This method tends to be more expensive, there is no control over the roll yields, and it does not provide exposure to commodity classes with no futures market. An enhanced index strategy is another method that allows managers to have the flexibility to avoid the negative roll and is performance-incentive fee-based. Last, the best strategy is a combination of enhanced index and active strategy through long/short positions in different futures market. This is an opportunistic strategy that would benefit the fund.

The benefit of commodities is diversification, in that there are low correlations with other asset classes, such as stocks, bonds, and real estate, and they provide an equity-like return. Historically, when stocks and bonds have had negative returns, commodities have performed well. Commodities have the effect of smoothing a portfolio's total variability. Commodities are a hedge against inflation, in that when inflation rises commodities prices rise also while stocks and bonds typically decline. Commodities have also performed best when interest rates increased, while stocks and bonds had the worst returns. There are two indices in which commodities are used; Goldman Sachs Commodity Index (GSCI) and the Dow Jones-AIG Commodity Index (DJ-AIGCI). The Treasurer's Office would recommend an active strategy with enhanced index, not necessarily following these indices, but actively managing through overweighting and underweighting commodities with some private equity partnerships. The benchmarks would be crafted to reflect those combinations.

Chief Investment Officer Berggren stated that this issue will be discussed at a future meeting, along with a recommendation. In response to a question from Mr. Fisher, Ms. Berggren stated that the main reasons for investing in commodities are that they are defensive, uncorrelated, perform well in both up and down markets, and are a hedge against interest rates.

8. **REPORT ON DIVESTMENT OF UNIVERSITY HOLDINGS OF COMPANIES WITH BUSINESS OPERATIONS IN SUDAN**

Chief Investment Officer Berggren recalled that on March 16, 2006, The Regents approved a policy regarding divestment of University holdings in companies with business operations in Sudan. This policy instructed the Office of the Treasurer to report on the status of said policy to the Committee on Investments as part of the annual review of the overall Investment Policies for the University of California Retirement Plan (UCRP) and the University of California General Endowment Pool (GEP). Ms. Berggren reported on the status on this matter as of mid-February, 2007.

On March 16, 2006 The Regents identified nine companies to be divested from all actively managed, publicly traded equity portfolios in the UCRP and GEP.

On March 25, 2006, legislation was chaptered in California that provided The Regents indemnification for actions taken under this policy.

Divestment Progress Report

The Indemnification Law was signed on September 25, 2006, marking the beginning of an 18-month window during which all shares of the nine companies must be divested.

The estimated value of the nine companies targeted for divestment held in separate accounts as of September 30, 2006 was $14.5 million. This amount represented approximately 0.04 percent of all public equities in the UCRP and the GEP at that time.

As required by the policy, the Office of the Treasurer contacted appropriate parties (UC Separate Account Managers, UC Commingled Account Managers, and UC Campus Foundations) with relevant information regarding investing in companies with business operations in Sudan.

March 25, 2008 marks the close of the 18-month window within which divestment must be completed. Restrictions prohibiting future purchase of companies targeted for divestments have been included in investment managers' guidelines.

Dialogue Progress Report

In addition to the nine companies identified for divestment, four companies were identified for ongoing dialogue. Of these four, one previously engaged does not meet The Regents' criteria for divestment and therefore no further dialogue is planned. The Office of the Treasurer continues to engage the remaining three in dialogue with the goal of improving understanding of the companies' business activities in Sudan. There is no change in the status of any of these companies which would cause the Chief Investment Officer to alter her initial recommendation.

Mr. Fisher recalled the issue of apartheid in South Africa, and was struck that the forces for change in the country were Coca-Cola and IBM. The unintended consequence of divestiture was to force these companies to leave South Africa. Ms. Berggren stated that one of the key criteria for identifying the companies from which UC would divest was to ensure that the companies were furthering the government's position in Sudan, not those that were improving the situation.

Regent Ledesma thanked the Committee for leadership in this area. She asked what percentage of the total public equity holdings in these companies the University will be divesting, given that commingled funds were not targeted. Ms. Berggren estimated $20 million and stated that approximately the same percentage has been divested and that the Treasurer's Office will continue to work with the managers of the commingled funds. Regent Ledesma asked if the fund managers have been encouraged to make attempts to divest sooner. Ms. Berggren stated that the Treasurer's Office made clear to the fund managers that divestiture should occur as prudently and as quickly as possible.

Regent-designate Allen asked if the Treasurer's Office has recently followed up with the Foundations and the commingled account managers regarding indemnification. Ms. Berggren stated she will inquire as to what the Foundations have done in the interim. She instructed Counsel O'Neill to check with the Foundations specifically regarding indemnification.

Regent-designate Allen asked about the correspondence with the remaining companies. Ms. Berggren stated that Finemaccina is no longer operating in Sudan. Schlumberger Limited does not do business with the government of Sudan. The Treasurer's Office has asked Schlumberger for clarification on the social welfare programs. Lundin Petroleum SA continues to do oil exploration only. This company is instructed to contact the Treasurer's Office once they begin producing oil and revenue to Sudan. Harbin Power Equipment Co. has been contacted numerous times and has refused to respond. Regent-designate Allen asked if other options have been considered. Mr. Fisher agreed that if Harbin is not willing to engage, the Treasurer's Office should consider divestment. Ms. Berggren stated that she will make the Treasurer's Office's intentions clear to this company.

9. **TRANSFER OF ASSETS AND LIABILITIES FROM THE UNIVERSITY OF CALIFORNIA RETIREMENT PLAN (UCRP) TO THE LOS ALAMOS NATIONAL SECURITY, LLC DEFINED BENEFIT PENSION PLAN AND AGREEMENT REGARDING THE ONGOING OBLIGATIONS OF THE DEPARTMENT OF ENERGY TO REIMBURSE THE UNIVERSITY FOR CONTRIBUTIONS TO THE UCRP**

Associate Vice President Boyette reported that the President will recommend to The Regents at the March 2007 meeting that in accordance with the provisions of the contract governing the transition to a successor contractor at Los Alamos National Laboratory (LANL), the Associate Vice President, Human Resources and Benefits, be authorized to enter into the following agreements on behalf of the University as sponsor of University of California Retirement Plan (UCRP) and The Regents as trustee of UCRP, provided the agreements are substantially as described below; to execute any regulatory filings associated with the transfer of assets and liabilities; and, pursuant to the Regents' authority to amend UCRP, to adopt any amendments to UCRP that are necessary to carry out the provisions of the agreements:

A. The Agreement Concerning the Transfer of Assets and Liabilities (Transfer Agreement) incorporates the terms agreed to by the University and the Department of Energy/National Nuclear Security Administration (DOE/NNSA) for the transfer of assets and liabilities from UCRP to the Los Alamos National

Security, LLC (LANS) Plan, including the amount of assets to be transferred and the documentation required to be provided to UC prior to the transfer of any assets.

B. The substantive terms of the agreement confirming the DOE/NNSA's ongoing funding obligation for UCRP benefits associated with LANL service (Funding Agreement) define the method for calculating any future funding shortfalls, commit DOE/NNSA to a schedule of payments to restore full funding of the separately accounted for segment within UCRP to which the assets and liabilities associated with members' LANL service are allocated (LANL Segment), and address other administrative matters.

Neither of these agreements will become effective, and no assets will be transferred, unless the Office of the General Counsel determines each is in substantially the form as described below and each has been properly executed.

In accordance with prior direction from The Regents, University administrators have consulted with the appropriate standing and special committees and task forces of the Academic Senate concerning the issues addressed in this item. At its meeting of February 28, 2007, the Academic Council unanimously endorsed the analysis and recommendation of the University Committee on Faculty Welfare, Task Force on Investment and Retirement (TFIR), to support entering into agreements with the substantive terms discussed with TFIR.

It was recalled that historically, under the University's prime contracts for LANL from 1943-2006, DOE/NNSA has reimbursed the University for contributions made to UCRP to meet the actuarial projections of the costs of the benefits accrued by LANL employees who participated in UCRP. The assets and liabilities associated with the UCRP benefits of University employees performing service at LANL have been allocated to the LANL Segment within UCRP and accounted for separately by The Regents' actuary each year since the early 1990s, at the request of DOE/NNSA.

Upon the expiration of the term of the existing contract on May 31, 2006 and consistent with their prior elections, active LANL employees who transferred employment to LANS began participation in the LANS Plan or became inactive UCRP members (if already vested) and began participation in the LANS market-based, defined contribution plan. The contract requires a transfer of UCRP assets and liabilities associated with the benefits of LANL employees who elected to participate in the LANS Plan. UCRP will retain the assets and liabilities for a supplemental benefit, referred to as the Capital Accumulation Payment (CAP) accounts, for all LANL employees, including those who elected to transfer their basic UCRP benefit to the LANS Plan. All references in this item to the "UCRP benefit" of a LANL employee refer only to the basic UCRP benefit. Consistent with the contract terms, modified as agreed upon by the parties to facilitate administration, all calculations regarding the share of UCRP assets and liabilities associated with LANL service that are subject to division between UCRP and the LANS Plan are based on a valuation date of May 31, 2006, determined by using the actuarial assumptions and methods established by The Regents for UCRP.

The formula outlined in the contract (Formula) for determining the amount to be transferred to the LANS Plan is defined as "A minus B," where "A" equals the market value of the assets allocated to the LANL Segment prior to transfer and "B" equals the liabilities associated with the UCRP benefits of the active LANL employees who elected to leave their benefits in UCRP and the group of former LANL employees who had already become disabled, retired, deceased, or inactive UCRP members by June 1, 2006, or their eligible survivors or beneficiaries. Both groups are collectively referred to below as "Retained LANL Payees." The Formula calculation results in a 100 percent funded status for the value of the benefits of Retained LANL Payees on a market value of assets basis immediately following the transfer.

Transfer Agreement

The Transfer Agreement contains the terms and conditions negotiated between the University and the DOE/NNSA for the transfer of assets and liabilities from UCRP to the LANS Plan. As of May 31, 2006, the total market value of UCRP assets allocated to the LANL Segment was $4,448,574,090 (A), and the liabilities for the UCRP benefits of the Retained LANL Payees as reported in the June 1, 2006 Special Interim Addendum Report for LANL were $3,169,811,239 (B). Following the Formula results in a May 31, 2006 market value of assets to be transferred (with adjustments as set forth below) from UCRP to the LANS Plan of $1,278,762,851 (A minus B). The transfer of assets and liabilities from UCRP to the LANS Plan is proposed to take place on or about April 2, 2007. The LANS Plan will then assume the liabilities transferred from UCRP effective as of June 1, 2006.

The amount of assets to be transferred will be adjusted for the total return earned by the UCRP portfolio from May 31, 2006, allocable expenses, buybacks for UCRP service credit, and distributions from UCRP to the small number of LANS employees who retired before the transfer of assets and liabilities to the LANS Plan as authorized by The Regents under Interim Authority in December 2006. The amount of assets to be transferred is considered to be the final transfer amount, with additional post-transfer adjustments, or true-ups, to reflect the final performance numbers of certain assets, other investment-related end-of-the-month accountings, any changes requested by the regulators, and data corrections.

Assets will be transferred on an in-kind basis under a method agreed upon by UC and DOE/NNSA. The investments to be transferred will be documented in writing and attached as an exhibit to the Transfer Agreement. The agreement allows the flexibility to take into account restrictions on certain investments, such as private equities, real estate, and emerging markets.

Prior to the transfer of any UCRP assets, DOE/NNSA will provide evidence that both the Transfer Agreement and the Funding Agreement have been executed or validly adopted and various other representations and assurances established by the University's legal counsel.

The transfer of assets and liabilities from UCRP to the LANS Plan will undergo regulatory review from the IRS to insure compliance with applicable federal tax laws and will be adjusted, if necessary, to conform to such requirements.

Funding Agreement

The Funding Agreement clarifies and implements the commitment by DOE/NNSA under the Contract to reimburse UC for any contributions made to UCRP to fund any existing or future funding shortfalls in UCRP attributable to the LANL Segment. It also establishes the methodology of calculating whether a current shortfall exists.

The DOE/NNSA has agreed to a target funded ratio for the LANL Segment within UCRP of 100 percent. Any year that the segment is underfunded (using UCRP actuarial assumptions), DOE/NNSA will begin seven years of level payments in an amount projected to restore full funding by the end of the seven-year term. The DOE/NNSA will generally be required to follow a similar seven-year payment approach with the corporate pension plans at its sites under recent changes in the pension funding rules that apply to private employer plans. Under the agreed-upon approach, reimbursements by the DOE/NNSA will be the greater of the payment calculated under the seven-year amortization method or the amount needed to meet liquidity needs for the LANL Segment. Liquidity needs are defined as three times the amount of benefit payments and expenses for the LANL Segment for prior plan year.

In return for clarifying its funding obligation and committing to a payment schedule if a shortfall in the LANL Segment funding occurs, the University agrees that the LANL Segment may remain within UCRP indefinitely, provided DOE/NNSA satisfies its payment obligations.

Because the liabilities of the DOE/NNSA are fixed under the contract as of May 31, 2006, DOE/NNSA will have approval authority over any ad hoc inflation-based increases in benefits of Retained LANL Payees even if the adjustments are proposed for all UCRP members and beneficiaries. DOE/NNSA will also have approval rights, which it cannot unreasonably withhold, for any proposed changes to UCRP that would:

- Affect only Retained LANL Payees or, in the future, any retained LANL Payees together with any similar retained members and beneficiaries associated with the Lawrence Livermore National Laboratory

- Raise costs for the Los Alamos Segment beyond that of UCRP generally; or

- o Use actuarial assumptions or an asset allocation for the LANL Segment that is different from the assumptions and allocation used generally for UCRP.

The Regents retains all of the fiduciary authority to manage UCRP, but will continue, as in the past, to provide notice to DOE/NNSA of changes to UCRP. The Regents will oversee administration and management of UCRP and its trust fund without the need for prior approval from DOE/NNSA, and take all actions it deems necessary to track the costs and expenses properly allocable to the LANL Segment. The University will continue to provide, at DOE/NNSA expense, an annual addendum report on the LANL Segment and such other calculations as may be required to administer the Funding Agreement. A portion of the costs of UCRP administration will be allocated as an expense to the LANL Segment.

When all benefits have been paid to the Retained LANL Payees, DOE/NNSA will be entitled to receive any surplus in the LANL Segment, subject to regulatory requirements on such a transaction, or will be required to pay any remaining deficit in the funding of the segment.

Actuarial Valuation

In order to determine the appropriate assets and liabilities of the LANL Segment, a special actuarial valuation was performed by The Regents’ actuary, The Segal Company, based on May 31, 2006 data. The valuation was performed in consultation with internal and external counsel and as agreed to with DOE/NNSA in order to carry out the terms of the Contract.

Consultation

University administrators have consulted with the appropriate representatives of the Academic Senate, including the University Committee on Faculty Welfare (UCFW), the UCFW Task Force on Investment and Retirement, the University Committee on Planning and Budget, the Academic Council Special Committee on the National Labs, and the Academic Council regarding these issues. In addition, University administrators have consulted, and will continue to consult, with various constituent groups on these issues.

The University will take appropriate action concerning proposed changes that may trigger notice, consultation, and meeting and conferring obligations under the Higher Education Employer-Employee Relations Act.

In response to a question from Regent-designate Allen, Ms. Boyette explained that this agreement is dealing with two sets of people. There were 6,600 people working at LANS who were not eligible for retirement nor desired to continue accruing retirement benefits, electing to transfer to a new plan at LANS. UC is transferring the benefits these employees had with UC to the LANS plan, from which point LANS will pay for new benefits the employees accrue. The other segment includes a large number of people who worked at LANS and had retired or retired when they discovered there would be a new employer, so they are already in the UC retirement plan and are not moving to LANS, and UC maintains responsibility for them.

10. **UC FOUNDATION ANNUAL ENDOWMENT REPORT FISCAL YEAR ENDED JUNE 30, 2006**

The Treasurer's Office compiled a report on the endowment and foundation assets of all the UC Campus Foundations for the Fiscal Year ended June 30, 2006. This report includes information on each Foundation's assets, investment and spending policies, and performance in comparison with benchmarks.

11. **REGENTS' INVESTMENT POLICY WITH RESPECT TO UC CAMPUS FOUNDATIONS**

Mr. Behrle inquired about the status of The Regents' investment policy with respect to Campus Foundations, which was passed at the last Regent's meeting but not in the form that the Committee on Investments and the Investment Advisory Committee last saw. The item had strong language with respect to rebalancing if a Foundation were outside the guidelines. He stated that UCLA Foundation is clearly outside the guidelines and had no plans to change its current allocation. Chief Investment Officer Berggren replied that to her knowledge UCLA is not outside the guidelines. Foundations must be within 10 percent of the target allocation of the GEP.

Committee Chair Wachter emphasized that the categories are very large: Equity, Fixed Income, and Alternatives. On Alternatives, Foundations can go as high as a 50 percent allocation. If allocations are outside the guidelines, a Foundation is required to request from the Committee an exception or waiver. The intent was not to require notification every time a change in allocation was made. Committee Chair Wachter concluded that what was agreed upon needs to be documented. Ms. Berggren explained that an interpretation memo has been put together and circulated for comment. University Counsel O'Neill reported that a number of comments have been received. Ms. Berggren stated that there will be an amendment to the initial policy.

The meeting adjourned at 4:05 p.m.

Attest:

Acting Secretary