The Regents of the University of California

COMMITTEE ON INVESTMENTS
INVESTMENT ADVISORY GROUP
May 7, 2008

The Committee on Investments and the Investment Advisory Group met jointly by teleconference on the above date at the following locations: Tom Bradley International Hall, Room 215, Los Angeles Campus; 1111 Franklin Street, room 12322, Oakland; 180 Geary St., Suite 500, San Francisco.

Members present: Representing the Committee on Investments: Regents Brewer, Dynes, Hotchkis, Schilling, and Wachter; Advisory member Croughan
Representing the Investment Advisory Group: Members Fong and Martin, Consultant Behrle

In attendance: Secretary and Chief of Staff Griffiths, Associate Secretary Shaw, Chief Investment Officer Berggren, University Counsel Birnbaum, and Recording Secretary Johns

The meeting convened at 1:50 p.m. with Committee Chair Wachter presiding.

1. **PUBLIC COMMENT PERIOD**

There were no speakers wishing to address the Committee.

2. **ADOPTION OF ASSET ALLOCATION AND INVESTMENT GUIDELINES FOR THE TOTAL RETURN INVESTMENT POOL (TRIP)**

The Chief Investment Officer recommended that the proposed asset allocation and investment guidelines for the Total Return Investment Pool (TRIP) shown in Attachment I be adopted.

[Background material was mailed to the Committee in advance of the meeting, and copies are on file in the Office of the Secretary and Chief of Staff.]

Chief Investment Officer Berggren recalled that the Regents were briefed in March 2008 about the establishment of a Total Return Investment Pool (TRIP) with a total return mandate responsive to campus needs. This fund will supplement the Short Term Investment Pool (STIP), which has a current income mandate and is appropriate for working capital needs.

The Committee on Investments will have responsibility for governance and oversight of the TRIP. The benchmark for the fund will be the weighted average of the same asset classes used in the General Endowment Pool (GEP) and UC
Retirement Plan (UCRP). The asset class guidelines and rebalancing policy will be identical to those governing the GEP and UCRP.

The asset allocation was developed to produce limited downside risk combined with some current income. The approved UCRP and GEP asset classes were used as a starting point. Ms. Berggren emphasized that the initial allocation excludes all assets with limited liquidity: emerging market equity and debt, and “alternative” assets. It also excludes currency risk. The portfolio contains currency hedged non-U.S. equity and debt in developed markets. The proposed asset allocation consists of 75 percent fixed income and 25 percent equity.

In response to a question asked by Committee Chair Wachter, Ms. Berggren explained that “hedged non-U.S. equity” refers to the currency hedged portfolio.

The TRIP is expected to have a 6.6 percent total return, higher than the 5.2 percent return of the STIP. However, the TRIP will have a higher volatility level – 5.2 percent – compared to 3.8 percent for the STIP, and comparable downside risk. Ms. Berggren noted that there was much discussion with the campuses about the -3.3 percent downside risk for the TRIP, compared to the STIP downside risk of -3.1 percent. The Office of the Treasurer is proposing a rebalancing policy of ±10 percent of the broad asset class targets.

Committee Chair Wachter asked how the TRIP could have comparable downside risk with 25 percent in equities and the rest in cash. Managing Director Phillips explained that, going up the efficient frontier from an all-bond or an all-fixed income portfolio, one can add a small amount of equity to raise the expected return and lower the volatility. At a certain point, after continuing to add equity, volatility increases. Mr. Phillips described this process as diversification.

In response to a question asked by Committee Chair Wachter, Mr. Phillips explained that the STIP consists of 75 percent intermediate fixed income and 25 percent cash. Managing Director Wedding observed that maximum maturity in the STIP is currently five-and-a-half years; average maturity is between one-and-a-half and two years.

Ms. Berggren noted that the TRIP allocation, with 25 percent equity, does not produce lower volatility; the downside risk for the two portfolios is almost the same. Committee Chair Wachter asked about the amount of downside risk in a one-and-a-half year maturity period. Mr. Wedding recalled that the TRIP has a different allocation than the STIP. He stressed that equities are negatively correlated with fixed income. Committee Chair Wachter opined that there is almost no downside risk in a one-and-a-half year average maturity fixed income portfolio, unless there is credit risk. Ms. Berggren confirmed that there is credit risk.
The proposed benchmark for the TRIP is the weighted average of the asset classes of the GEP and UCRP. The spending rate will be established by the Committee on Finance, and will be reviewed and approved annually by the Committee on Investments. The target spending rate for the TRIP will be equal to the long-term expected return of the portfolio. Dividends will be paid annually. The target spending rate will be the maximum, with a minimum spending rate equal to current income. Unrealized gains will be distributed only if the portfolio is above cost.

The effective date for implementation of the portfolio is July 1, 2008. It will be open to the campuses on August 1, 2008. Initial campus contributions will be between $1.5 billion and $2 billion. Assets will be transferred from the STIP over a two-month period.

Committee Chair Wachter asked if the campuses’ participation is mandatory or voluntary. Ms. Berggren replied that the campuses sign up voluntarily. She described the process of how allocations were determined in consultation with the campuses. The fund is essentially campus money, and its asset allocations come from campus suggestions.

Regent Hotchkis requested clarification on the purpose of the TRIP. Ms. Berggren recalled that there are currently $9.8 billion in the STIP. There has been a desire, particularly on the part of Chairman Blum, to increase the return on the STIP. This can only be done by examining the composition of balances in it. The goal is to improve the overall return on the University’s total investment pool. The campuses’ objective is to avoid an inordinate amount of risk on this money. She described the TRIP as a first step.

In response to a question asked by Regent Hotchkis, Ms. Berggren noted the slight improvement in payout for the TRIP over the STIP – 6.6 percent as opposed to 5.2 percent. She emphasized that this was a collaborative effort with the campuses, which know what their money is needed for. She observed that some institutions manage their investment pools like an endowment.

Due to lack of a quorum, action on this item was postponed. (See p. 12, Item 6)

3. **FIXED INCOME PROGRAM REVIEW**

[Background material was mailed to the Committee in advance of the meeting, and copies are on file in the Office of the Secretary and Chief of Staff.]

Managing Director Wedding described the market environment for fixed income investors as extraordinary over the last nine months. He began his presentation with a chart of the first quarter assets under management as of the end of March 2008. He called attention to the total of $29 billion. The bulk of this amount is internally managed in total return and current income portfolios. Treasury
inflation-protection securities (TIPS) and non-dollar government bonds are passively managed allocations.

In response to a question by Committee Chair Wachter, Chief Investment Officer Berggren stated that the fixed income portfolio is almost entirely actively managed. Mr. Wedding clarified that non-dollar government bonds are non-U.S. government bonds, the World Government Bond Index ex-U.S.

Investment Advisory Group member Martin asked if the emerging market segment of the assets under management is hedged back to the U.S. dollar. Mr. Wedding answered that this allocation is in U.S. dollars, like the Emerging Markets Bond Index Plus (EMBI+) Sovereign Index, external debt denominated in U.S. dollars. He noted that this might change, to include some local currency emerging market debt.

Mr. Wedding referred to the present stressful and tumultuous period for markets, especially credit markets. The sub-prime residential mortgage market served as a catalyst, and the shock has been felt through all credit or fixed income markets. The current credit market is characterized by massive deleveraging, forced sales, illiquidity, and poor price discovery. Broker-dealers, investment banks, and money center banks are not making fixed income markets in an efficient manner. As a result, many of the University’s mortgage-backed securities and credit assets are arguably priced for risk of default consistent with a depression, not just a moderate recession.

Next Mr. Wedding examined returns for the core UC Retirement Plan (UCRP), General Endowment Pool (GEP), and defined contribution (403(b)) bond funds. He described the absolute level of returns as quite good. In the first quarter there were returns for the three portfolios between 1.5 percent and 2 percent, and between 7 percent and 8 percent for the fiscal year to date. He suggested that the UCRP might generate double digit returns for the fiscal year. As to relative performance, the portfolios are underperforming materially due to the mortgage-backed security and credit sectors. He cited a significant mark-to-market volatility in these assets. Mr. Wedding emphasized that there have been no defaults or missed coupon payments in the University’s portfolio.

Ms. Berggren noted the non-benchmark nature of some mortgages. Mr. Wedding elaborated that the benchmarks for the UCRP and GEP have agency mortgage-backed securities but no non-agency securities.

Committee Chair Wachter asked about difficulties with pricing and expressed concern about the accuracy of the stated mark-to-market returns. Mr. Wedding responded that there are significant difficulties with pricing. The price discovery of some assets, which are normally liquid and easily traded, is now broken. Ms. Berggren stated that this point should be pursued further.
In response to a question asked by Committee Chair Wachter, Mr. Wedding stated that it is currently not possible to obtain reasonable prices for mortgage-backed, non-agency securities. Any trade that has taken place lately has more than likely been a forced liquidation. He noted that the Securities and Exchange Commission has instructed broker-dealers that they are not obligated to use the mark-to-market price in a situation of forced liquidation.

Committee Chair Wachter asked how other pension and endowment funds are dealing with the pricing problem. Mr. Wedding responded that the University uses two or three pricing services, through its custodian accounting process. He noted that one of the University’s custodians, Bear Stearns, is no longer trading securities.

Mr. Martin stressed that the University’s objective should be to get a good absolute return over time. He acknowledged that month-to-month and quarter-to-quarter reporting might be unclear in the current market valuation pricing environment. Mr. Wedding responded that the University takes a long-term point of view on its investments.

Committee Chair Wachter asked what proportion of the portfolio consists of mortgages, and if there are any sub-prime mortgages. Mr. Wedding stated that mortgages make up approximately 30 percent of the UCRP, and 40 to 45 percent in the GEP and defined contribution plan, consistent with the Lehman aggregate benchmark. He confirmed that there are sub-prime mortgages in the portfolio.

Mr. Wedding then presented a peer group comparison of UC’s fixed income returns with those of publicly available mutual funds with well-known fixed income managers, using the Lehman aggregate benchmark. He observed that there have been significant dislocations and volatility; funds that have outperformed by using non-agency securities now have a more significant problem.

In response to a question asked by Committee Chair Wachter, Mr. Wedding clarified that the Capital Group’s fixed income portfolio underperformed for the quarter by 3.57 percent and for the last nine months by 7.55 percent. He ascribed this underperformance to mortgage-backed securities in their portfolio.

Committee Chair Wachter noted that Pacific Investment Management Company (PIMCO) outperformed the benchmark for the year to date by 4.07 percent. Ms. Berggren observed that PIMCO has followed a unique strategy. Mr. Wedding stated that many funds engage in a strategy of owning Treasury bond futures rather than Treasury bonds and manage a short-term cash pool. Unfortunately, the short-term cash pool may include sub-prime floaters and asset-backed commercial paper, which lost significant amounts of money.
Mr. Wedding went on to describe the residential mortgage-backed securities market as broken. A secondary market for non-agency, mortgage-backed securities is non-existent. Borrowers are paying 100 to 125 basis points above agency rates for jumbo loans above a conforming limit, compared to 25 basis points a year ago. Loans are not always available. The mortgage finance market is not functioning as it should, despite efforts by the federal government.

Mr. Wedding explained that Fannie Mae, Freddie Mac, and Ginnie Mae are government agencies or government-sponsored entities which insure principal and interest payments on pools of mortgages. They determine criteria for these pools, such as size or structure of the loan and credit quality of the borrower. The most actively traded securities in the mortgage-backed market are agency securities. A jumbo loan, larger than a conforming limit, is automatically a non-agency security. The bank making the loan can keep the loan on its balance sheet or securitize it, in which case it becomes a non-agency security. The status of the security may also depend on the credit quality of the borrower. Non-agency securities are not included in common benchmarks, despite their prevalence in the mortgage market as a whole, currently over 30 percent.

Next Mr. Wedding discussed a chart reflecting the discount for non-agency, mortgage-backed securities versus agency securities with similar characteristics, since the beginning of 2006. Non-agency securities are cheaper and have a higher yield than agency securities.

Committee Chair Wachter asked about the ratings of the two kinds of securities. Mr. Wedding stated that the rating of an agency security is AAA by virtue of the guarantee of Fannie Mae, Freddie Mac, and Ginnie Mae. The rating of a non-agency security may be AAA by virtue of the structure of the security – prime borrowers in the pool of mortgages, and tranching or securitization that provides credit enhancement. He clarified that the chart presents price spreads for AAA non-agency, mortgage-backed securities.

Mr. Martin observed that credit ratings in this area are unreliable and that credit rating agencies have made significant mistakes in their models. He noted a time lag in the default process, such that there may be default frequencies to come whose effect has not yet been felt. He asked how the University can be comfortable with this class of securities, given these two risk factors.

Mr. Wedding responded that the University does not rely on rating agencies to guide investing in any asset classes. In the case of mortgage-backed securities, and non-agency securities in particular, the Office of the Treasurer carries out extensive modeling and stress testing for different economic scenarios and examines the credit metrics of underlying mortgages. Most borrowers of University-owned mortgages are prime borrowers. The Office of the Treasurer examines the performance of the pool of mortgages from inception to the date the
University considers buying them. The University strives to buy seasoned mortgages for which pre-payment as well as credit behavior is known.

Mr. Martin asked if the University owns any adjustable-rate mortgages. Mr. Wedding replied that the University owns some hybrid adjustable-rate mortgages, with a fixed rate for 3, 5, or 7 years which then reverts to a floating rate. He emphasized that the University has a rigorous credit process to test the credit-worthiness of borrowers.

Mr. Martin asked if any of the portfolios in question use credit enhancement, and if counterparty risk must be taken into account. Mr. Wedding responded in the negative. There is credit enhancement of the structural variety. Given the lack of guarantee for a non-agency security, the security structure is tranched so that lower levels absorb the first losses. Typically, the University is in the top level and has 7 percent to 15 percent credit enhancement of this type. In addition, the loan-to-value ratio is about 70 percent and borrowers have 30 percent equity. He affirmed that the University examines underlying assets. He observed that more information on individual assets is available in a non-agency mortgage pool than in an agency pool; the agencies do not provide information on their borrowers.

Regent Hotchkis asked if the most significant difficulties are in the AAA area. Mr. Wedding answered in the negative; the structural credit enhancement functions such that BBB, and BB and B, if they are present, absorb the first losses.

Mr. Martin stated that there is no longer a clear division between AAA and other levels. He stressed the importance of analyzing underlying assets rather than relying on credit rating agencies.

Mr. Wedding then discussed the importance of the vintage year. If a mortgage has an inception date of early 2006 or earlier, it was provided using better underwriting standards. Delinquency patterns in mortgages become apparent during the first two or three years.

Regent Brewer asked at what point the University buys mortgages. Mr. Wedding responded that 80 percent to 85 percent of the University’s non-agency portfolio has two years of seasoning.

Regent Hotchkis asked if, in Mr. Wedding’s estimation, the current turbulent market situation is more than halfway over. Mr. Wedding described the current situation as a selling climate, when individuals lose financing and are forced to liquidate assets held using borrowed money, and there are no bids.

Mr. Martin described this as a dramatically inefficient market. Mr. Wedding observed that there might be extraordinary opportunities in this market. When broker-dealers are unwilling to provide liquidity, pristine credit quality securities
can be bought at discount. The University has a pool of non-agency, 30-year pass-through securities with three years’ seasoning and no delinquencies whatsoever – in this last respect, better than 90 percent of underlying mortgages in agency securities. These securities were bought at a large discount. Returning to Regent Hotchkis’ earlier question, he opined that liquidation is now driving the situation and that the current market condition is more than halfway over, after climaxing in March.

Committee Chair Wachter asked which funds were to purchase these securities – short-term monies or money from the equity portfolio. Mr. Wedding recalled that in December 2007 the TIPS allocation was rebalanced to its target level after its outstanding performance. The funds thus released were used for selected high-quality, mortgage-backed securities and corporate securities, after due diligence.

Committee Chair Wachter asked if TIPS performed well due to the expectation of greater inflation. Mr. Wedding ascribed this performance to the fact that Treasury rates have plummeted and to the environment of relatively high headline inflation, with rising oil prices and a 4 percent annual increase in the consumer price index.

Committee Chair Wachter asked if any part of the portfolio other than government securities was not affected by these conditions. Mr. Wedding stated that emerging market bonds performed better than expected, outperforming other credit products.

Mr. Wedding briefly noted a chart displaying changes in weights in the mortgage-backed securities portfolio over the last several quarters. He then reported that the University owns a small amount of sub-prime AAA floaters, currently somewhat less than 3 percent of the fixed income allocations. These are super-senior securities which have retained their AAA rating, in spite of aggressive action on sub-prime downgrades by rating agencies. The Office of the Treasurer models them continuously, and its judgment is that they are money-good. They are short-term securities and are paying down rapidly; they are expected to mature in less than a year.

Ms. Berggren emphasized the duration and depth of work on this strategy, which was developed before the sub-prime situation developed. Mr. Wedding concurred, noted the work done in this area by Senior Portfolio Manager Satish Swamy, and stressed the importance of knowing who is originating and structuring mortgages. The University’s sub-prime mortgages will experience their first principal loss if there is a 50 percent decline in home prices, and if 50 percent of the borrowers in these pools default. This situation is conceivable but not very probable.

Mr. Martin observed that there are also opportunities at present to buy corporate securities with high credit quality at significant discounts, and asked if UC is doing so. In response, Mr. Wedding discussed UC’s credit portfolio strategy.
Prices in this market do not reflect a reasoned estimate of defaults and risk, but rather panic liquidation of securities. There are significant opportunities. He recalled that, in the three-and-a-half years before mid-2007, spreads were narrow, volatility was low, and opportunities to outperform or to generate alpha were extremely limited. Credit risks were stretched beyond a prudent measure, and there has been a reaction to this over the last nine months. In this situation, when spreads were compressed and there was little distinction between mediocre and good credits, the University bought good credits and made significant investments in financial companies, which had a low risk of leveraged buyout, good capital cushions, and high ratings. Since then, issues have emerged which the University and regulators were not aware of, such as leveraging up off balance sheets through special investment vehicles. The University has experienced mark-to-market declines in the financial sector.

Mr. Wedding then turned to a chart showing the option-adjusted spread of the Lehman Aggregate Investment Grade Credit Sector. He described it as arguably the most widely used credit benchmark in the world and pointed out that the current spread has exceeded the widest levels of the last 20 years, and is now almost double the spread of the early 1990s, during the last moderately severe recession. The illiquidity and deleveraging that have affected the mortgage-backed securities sector have affected the corporate credit sector as well. There are good investment opportunities, but the University needs to be judicious. The current recession may be mild or sharp. Credit quality is deteriorating. The market is demanding a greater return for corporate securities, beyond what would be expected in a normal recession.

Regent Hotchkis asked about the reason for the rebalancing of the TIPS allocation and the use of this money to purchase mortgage-backed and corporate securities. Mr. Wedding explained that TIPS was rebalanced to its target allocation. The Office of the Treasurer follows a discipline of rebalancing to strategic allocations over time. Ms. Berggren commented that the TIPS return was 15.6 percent and seemed abnormal at a time when investors were looking for the lowest risk possible, and that there may be more attractive assets in the future. The allocation in emerging markets was brought down to market weight last year for the same reason.

Mr. Martin asked if the Office of the Treasurer ever shorts debt securities. Mr. Wedding responded that this is not within the purview of the Office of the Treasurer, but stated that this is done implicitly by being underweighted versus the benchmark.

Mr. Wedding then discussed returns from the Short Term Investment Pool (STIP) and the Savings Fund. Compared to some of its peer group, the University has avoided setbacks in the short-term credit market. There are investors who have lost significant amounts of money in short-term funds from sub-prime paper or asset-backed commercial paper related to a special investment vehicle which is
now bankrupt. The University has not done this; Mr. Wedding described this as a “good miss” on UC’s part. The University has taken advantage of an extraordinary environment – ongoing dislocation in the money market. Many of the University’s short-term investments are related to the London Inter-Bank Offer Rate (LIBOR). They may be priced from LIBOR, or the borrower may use LIBOR as an alternative. LIBOR remains elevated relative to federal funds and short-term Treasury rates.

Committee Chair Wachter asked what a safe investment from LIBOR would be. Mr. Wedding suggested a three-year floater issued by a high-quality industrial company, such as General Electric. He stated that the money market dislocation reveals itself in the University’s securities lending program. The University can lend securities and invest the income in LIBOR-based assets. Securities lending income has been high.

Ms. Berggren described the current market environment as unusual, in that AAA credits are coming into the market with new securities. Mr. Wedding concurred, and observed that, in spite of the credit crisis, corporate investment-grade issuers can borrow money in the public market. There are also high-quality borrowers in this market, and the University has been investing in them. Ms. Berggren observed that the University has been able to upgrade the quality of the portfolio consistently in this market and obtain better returns.

Mr. Wedding concluded by emphasizing that the current environment for fixed income investing is extraordinary; the current illiquidity and other factors are unlike anything he has experienced in 30 years. There are significant risks and opportunities. The UC portfolio has avoided defaults, but the mark-to-market underperformance is drastic, the worst relative performance he has experienced in 10 years at UC. He opined that the University’s portfolios are well positioned to outperform over the next one to three years.

Ms. Berggren stressed that the Fixed Income Investments team is experienced and has worked together over time and through cycles.

4. ADOPTION OF EXPENDITURE RATE FOR THE GENERAL ENDOWMENT POOL (GEP) FOR FY 2008-09

The President recommended that, with the concurrence of the Committee on Finance, the expenditure rate per unit of the General Endowment Pool (GEP) for expenditure in the 2008-09 fiscal year 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.

[Background material was mailed to the Committee in advance of the meeting, and copies are on file in the Office of the Secretary and Chief of Staff.]
Assistant Vice President O’Neill began his presentation by noting that this is the eleventh year in which the Committee on Investments and the Committee on Finance have adopted an expenditure rate for the GEP. Previously, the ordinary income generated each year was distributed to each participant in the endowment pool. In 1998, the Regents adopted the Uniform Management of Institutional Funds Act and a total return expenditure formula. The target rate was identified as 4.75 percent of a 60-month moving average. In order to avoid a significant increase from one year to the next, this rate was not implemented initially but phased in over several years. The current item proposes that the expenditure rate for the next year remain at the 4.75 percent of a 60-month moving average. Mr. O’Neill stated that maintaining this rate will result in a significant increase in distributions from the endowment pool. The proportion eligible for total return will increase from $194 million to $217 million. This is a significant increase from one year to the next. The suggestion to maintain this payout rate is based on current and long-term market factors reviewed by the Office of the Treasurer and the Office of the President.

Committee Chair Wachter requested clarification of the 60-month moving average. Mr. O’Neill explained that it refers to the average market value of a unit in the GEP.

Committee Chair Wachter asked if a hypothetical amount of $6 billion in the endowment would result in a $300 million payout. Mr. O’Neill estimated that the payout, as a percentage of current market value, would be approximately 4.2 percent, based on performance of the last 60 months.

Committee Chair Wachter asked about the rationale for taking a percentage of a five-year average. Chief Investment Officer Berggren responded that this is to ensure availability of funds for future use. If expenditures were made from current returns, there would be a significant spending rate in a good market year and a low rate in a bad market year. The proposed approach allows for a consistent amount that can be paid from the endowment. Ms. Berggren described this as a smoothing concept.

Committee Chair Wachter observed that there should be a legitimate increase in the portfolio over five years. He expressed appreciation for the need for smoothing, but noted that even a 7 percent return would result in a difference of almost 50 percent over five years. He outlined a hypothetical situation in which $100 in the endowment has grown to $150 over five years, and the expenditure would be 5 percent of $125. Ms. Berggren noted uncertainty in the market for any specific period and recalled that some institutions use a shorter, three-year horizon. She stressed the importance of considering overall portfolio return, inflation, and payout, and the need to ensure the availability of funds in the future. She recalled that education inflation has been much higher than overall inflation. In response to a second question asked by Committee Chair Wachter,
Ms. Berggren noted that an annual expenditure rate of 5 percent rather than 10 percent affects the spending rate available for future students.

Committee Chair Wachter observed that, by using the five-year average, the formula overcounts good years in the future and undercounts good years in the present. Mr. O’Neill noted that, even during years with weak performance, the five-year moving average allowed the University to increase distribution.

Regent Hotchkis asked to whom and how the funds are distributed. Mr. O’Neill responded that the GEP is currently approximately $6.5 billion. Counting this and the campus foundation endowments, the University has a total of approximately $10 billion in endowments. Most of these funds are restricted by donors for specific purposes, such as research, scholarships, or endowed chairs. Endowed chairs now constitute approximately $1.8 billion of the total endowments; they have increased significantly during the last ten years. Very few of the University’s endowment funds are unrestricted.

In response to a question asked by Committee Chair Wachter, Mr. O’Neill pointed out that the annual endowment report prepared by the Office of the Treasurer is broken down by campus. Older, more established campuses such as Berkeley and UCLA have larger endowments. He and Ms. Berggren noted that some campuses have a higher spending rate than the GEP. Mr. O’Neill clarified that the GEP funds go directly to the campuses for their expenditures, not to the campus foundations.

Due to lack of a quorum, action on this item was postponed. (See p. 13, Item 9)

[At this point President Dynes joined the meeting.]

5. **APPROVAL OF MINUTES OF PREVIOUS MEETING**

Upon motion duly made and seconded, the minutes of the Open Session meeting of March 19, 2008 were approved.

6. **ADOPTION OF ASSET ALLOCATION AND INVESTMENT GUIDELINES FOR THE TOTAL RETURN INVESTMENT POOL (TRIP)**

Upon motion duly made and seconded, the Committee approved the Chief Investment Officer’s recommendation and voted to present it to the Board. (See p. 1, Item 2)
7. APPROVAL OF PERFORMANCE OBJECTIVES FOR FY 2008-09 FOR THE TREASURER’S ANNUAL INCENTIVE PLAN (AIP)

The President and Mercer Investment Consulting recommended that the asset class investment performance objectives shown in Attachment II be adopted for the FY 2008-2009.

[Background material was mailed to the Committee in advance of the meeting, and copies are on file in the Office of the Secretary and Chief of Staff.]

Chief Investment Officer Berggren observed that there have been no changes in objectives or participants in this annual incentive plan.

Upon motion duly made and seconded, the Committee approved the President’s recommendation and voted to present it to the Board.

8. APPROVAL OF PARTICIPANTS, OBJECTIVES, AND WEIGHTINGS FOR FY 2008-09 FOR THE TREASURER’S ANNUAL INCENTIVE PLAN (AIP)

The Chief Investment Officer recommended approval of a list of participants, objectives, and weightings for FY 2008-09 for the Treasurer’s Annual Incentive Plan (AIP), shown in Attachment III.

[Background material was mailed to the Committee in advance of the meeting, and copies are on file in the Office of the Secretary and Chief of Staff.]

Chief Investment Officer Berggren explained that new staff members have joined the Office of the Treasurer. The item is consistent with the Regents’ approval of different weightings for participants.

Upon motion duly made and seconded, the Committee approved the Chief Investment Officer’s recommendation.

9. ADOPTION OF EXPENDITURE RATE FOR THE GENERAL ENDOWMENT POOL (GEP) FOR FY 2008-09

Upon motion duly made and seconded, the Committee approved the President’s recommendation and voted to present it to the Board. (See p. 10, Item 4)

10. ANNUAL REPORT ON REGENTS’ INVESTMENT POLICIES ON TOBACCO AND SUDAN

[Background material was mailed to the Committee in advance of the meeting, and copies are on file in the Office of the Secretary and Chief of Staff.]
Chief Investment Officer Berggren recalled that the Regents’ tobacco exclusion policy was adopted on January 17, 2001. The Regents approved a policy on divestment of University holdings in companies with business operations in Sudan on March 16, 2006. The Office of the Treasurer is required to report annually on the status of these policies to the Committee on Investments.

The total public equity impact of the tobacco policy on the portfolio in 2007 was $63.8 million. The cumulative impact from 2001 to 2007 was $308.3 million. The U.S. equity impact in 2007 was $40.2 million, with a cumulative impact of $252.4 million. The non-U.S. equity impact was $23.5 million in 2007, with a cumulative impact of $55.9 million.

In response to a question asked by Committee Chair Wachter, Ms. Berggren confirmed that these opportunity cost figures represent what the University would have earned if it put its stock back. She stressed that excluding anything from an investment portfolio always has an effect, positive or negative.

Ms. Berggren then discussed the effect of the Sudan policy. The cumulative return of the Morgan Stanley Capital International (MSCI) World ex-U.S. Index during this period was 32.98 percent. The Office of the Treasurer adjusted this figure for the approximately 103 percent return on the excluded stocks. This yielded a return on the “Sudan Free Index” of 32.54 percent. The difference between the 32.98 percent and the 32.54 percent produces a determination of a $45 million opportunity cost for the University for one year.

In response to a question asked by Regent Hotchkis, Ms. Berggren confirmed that a large part of this loss is due to the exclusion of PetroChina.

Regent-designate Scorza asked about the performance of funds that would have been invested in tobacco or companies like PetroChina. Ms. Berggren and Committee Chair Wachter explained that these funds are spread out among the remaining stocks. The same amount of money is being invested in a smaller number of stocks. Investment Advisory Group member Martin confirmed that the return on money reallocated in portfolios is known.

Committee Chair Wachter discussed how, previously, the removal of Philip Morris stock from a portfolio would entail the loss of other companies such as Kraft and Nabisco. Ms. Berggren observed that companies change over time; a tobacco company may become a multinational with only a small percentage of its activity in tobacco.

Regent Brewer asked if the students are informed about the effects of these investment policies. Regent-designate Scorza stated that, as students become more interested in UC investments, they gain greater understanding of the effect of UC’s investment policies on families and others who receive returns from those
investments. He asked if there is an overarching policy for the University’s investment strategy regarding companies like PetroChina and Philip Morris.

Committee Chair Wachter noted that the campaign for Sudan divestment was well thought out and carefully documented, with an effort to minimize disruption. It was clearly attached to concerns about genocide, included indemnification, and was careful to define which companies were objectionable. Ms. Berggren stated that the Office of the Treasurer worked with the then student Regent to examine closely the work done by different companies in order not to exclude companies that might be helping people in Sudan. She cautioned against blanket decisions about all companies doing business in a country.

Ms. Berggren stated that the Regents now have a defined policy according to which the University will not make investment decisions based on social issues. Mr. Martin recalled that he served on the committee that examined this issue, and that it included students and faculty. The committee considered the policies of other universities and of state organizations. Regent-designate Scorza asked if this process of examination can continue.

University Counsel Birnbaum pointed out that this process is legally mandated because of the Regents’ fiduciary obligations. Fiduciaries may not make financial decisions based on personal preferences or conceptions of right and wrong. Along with other issues, they must consider the financial impact on the institution of the decisions they make. Mr. Birnbaum observed that, although the discussion and implementation of Sudan divestment was very careful, it nevertheless underestimated the actual financial impact.

Committee Chair Wachter recalled that much of the $45 million cost was due to PetroChina and the unexpected rise in the price of oil. He emphasized the importance of benchmarks and the Regents’ responsibility to try to make the University’s portfolio perform better than the market, and certainly not worse than the market, in order to protect pensions and the UC endowment. By removing investments, an institution will deviate from the benchmark and more than likely perform worse than the benchmark.

Mr. Martin added that investment research has established clearly that when options are restricted, returns are poor. Socially motivated investing has always underperformed compared to investing that is freer. In the case of Sudan divestment, UC needed indemnification because people who receive pensions could sue the University. The University could be sued on the grounds that the endowment money is to be used for academic purposes.

Ms. Berggren noted that one of the material managers in UC’s equity portfolio has chosen to overweight tobacco significantly. He has a positive return for all his other investors, but a negative return for UC. Committee Chair Wachter noted the development of “green-sensitive” mutual funds weighted for companies that
are greener. There is thought about these issues in the investment world, but blanket decisions to divest will lead to losses.

11. REQUEST FOR PROPOSAL FOR GENERAL INVESTMENT CONSULTANT FOR THE REGENTS

Chief Investment Officer Berggren recalled that Richards & Tierney has served as the Regents’ general investment consultant for some time. She informed the Committee that Richards & Tierney has been taken over by another company. For this and other reasons, the University will not continue with their services. The Office of the Treasurer issued a Request for Proposal in January 2008 and has received proposals from eight institutions. A committee has evaluated the proposals, and three finalists will meet with senior Treasurer’s staff. A recommendation will be submitted to Committee Chair Wachter in July and to the Committee in September.

12. FIRST QUARTER 2008 AND FISCAL YEAR TO DATE INVESTMENT PERFORMANCE SUMMARY

[Background material was mailed to the Committee in advance of the meeting, and copies are on file in the Office of the Secretary and Chief of Staff.]

Chief Investment Officer Berggren reported that the UC Retirement Plan (UCRP) and the General Endowment Pool (GEP) had a negative performance for the quarter, but stressed that both remained in positive territory for the one-, three-, five-, and ten-year periods. The portfolio has also generated positive relative performance for these periods. The Short Term Investment Pool (STIP) has generated positive absolute and relative performance over all time periods.

Investment Advisory Group member Martin observed that the UCRP is managed differently than the GEP for risk management purposes. Ms. Berggren cited the different objectives of the two funds. Mr. Martin pointed out that the GEP has outperformed the UCRP for all periods, and questioned the benefit of managing the UCRP differently from the GEP. Ms. Berggren referred to the liabilities of the pension fund and recalled that, until 1999, it consisted of 60 percent domestic equity and 40 percent domestic fixed income. Its asset allocation has only been changed during the last two years. The UCRP currently has an absolute return allocation of 0.5 percent, with an objective of 5 percent. Ms. Berggren described this as an effective strategy which was employed effectively also for the GEP. She recalled that the GEP has a much longer time horizon.

Mr. Martin questioned the importance of the time horizon for guiding asset allocation strategy, given the proportion of liquid assets. Ms. Berggren noted that the U.S. market was down 11 percent in the quarter, while non-U.S. was down 9 percent. The current asset allocation strategy of the UCRP resulted in a 5 percent loss, a less significant loss than might have occurred. She stressed that
the UCRP is one of the few pension funds in the U.S. that is overfunded and has had no contributions for 17 years.

Committee Chair Wachter noted that there has been a significant change in asset allocation over the last three years. Before that time, the University owned bonds and stocks, but did not own real estate or absolute return. There was a change of Treasurer. The University decided to make changes first in the GEP, because it was a smaller fund to move, and the University could afford to be less risk-averse with it. The University began to include absolute return, international equities, and emerging market debt; it still has very little real estate, private equity, or hedge funds in the portfolio. The same process was begun a year later for the UCRP, so that this work is still in process. Committee Chair Wachter opined that the University’s investment decisions for the UCRP were not mistaken, even in the current context. The UC portfolio could in fact include more hedge funds.

Mr. Martin opined that there may be opportunities to make the management of the two funds more similar. Ms. Berggren observed that it takes more time and effort to make investment changes for the $45 billion of the UCRP than for the $6.5 billion of the GEP. The University is careful about carrying out due diligence, as shown by this year’s performance on absolute return. She noted that UC has not been involved in a single defaulted hedge fund this year.

Managing Director Phillips commented that the proportions of good performing assets have always been higher in the GEP. There have been better returns built on that higher base. He stressed the difficulty of generating a return on the much larger UCRP, and that the asset classes cannot be moved quickly. Mr. Martin observed that there may be a five-year process for some asset classes.

Ms. Berggren noted that UC was one of the first entities to see the benefit of venture capital, which has performed well. There is no reason for UC not to consider absolute return in its portfolio when it has been comfortable with venture capital for thirty years. Committee Chair Wachter noted that, in 2006, UC did not own a single hedge fund. He expressed the wish to see more movement in hedge funds, private equity, and real estate. Ms. Berggren noted analysis carried out by the Office of the Treasurer on real estate investment.

Regent Hotchkis asked if the University is precluded from some private equity. Ms. Berggren responded that it is desirable to invest in top tier managers in private equity. The top tier managers in buyouts have outperformed those in venture capital. In 2002, the University began to invest in buyouts. Committee Chair Wachter stated that UC is not precluded from private equity, but that certain venture capital funds are not comfortable with the University’s public disclosure requirements. Ms. Berggren added that UC has an investment in all the top tier firms.
Ms. Berggren continued her presentation by pointing out that absolute return in the UCRP, with 52 basis points for the fiscal year to date, is performing as intended. She noted that the UCRP asset allocation is within policy guidelines. Turning to the risk decomposition of the portfolio, she pointed out that the portfolio has a negative bias toward High Yield, Large Value, Large Growth, and Mid Growth, and a positive orientation toward Credit, Mid Value, Small Growth, Non-U.S. Bonds, and Emerging Markets. The most significant contributors to the overall UCRP risk are its underweight in Large Value, Large Growth, and Mid Growth, and its overweight in Emerging Markets.

Ms. Berggren noted that 83 percent of the fixed income portfolio is in A-rated securities or better. The portfolio’s underweight in Government and overweight in Corporate and Mortgage have been materially negative.

Next Ms. Berggren discussed style exposures for the UCRP and GEP. These portfolios are oriented toward Earnings Variability, Trading, Value, and Volatility, rather than toward Growth, Momentum, and Size. The benchmark exposure on the risk side is limited. Turning to the non-U.S. equity portfolio, Ms. Berggren indicated that the most active risk derives from sector and country, with 28 and 37 basis points, respectively. In regional exposures, the portfolio is overweighted in Developed Europe and underweighted in Developed Asia, Japan, and Canada. The most significant sector exposures in this portfolio are underweighting in Energy, Materials, and Finance. The portfolio is overweighted in Capital Equipment and Consumer Goods.

Ms. Berggren pointed out that the private equity portfolio performed 11 percent over the benchmark. In 2001-06, when UC began investing in buyouts, the portfolio was 1,100 basis points above market. The portfolio has produced close to a 21 percent net return.

The performance of the GEP was better than that of the UCRP. Ms. Berggren identified the reasons for this better performance as lower U.S. equity exposure and greater weight in absolute returns, private equity, and real estate.

Ms. Berggren informed the Committee that the Office of the Treasurer is currently revising the equity portfolio. The Office has hired a new head of equity and has worked out a careful strategy. She emphasized the caution exercised in moving managers in this portfolio.

In response to a question asked by Mr. Martin, Ms. Berggren reported that all open positions except one in the Office of the Treasurer have been filled, a total of 17 positions. She briefly discussed the equity, absolute return, real estate, private equity, and risk management teams.

Committee Chair Wachter asked about indexing. Ms. Berggren responded that there was an opportunity in domestic equity to segment the Russell Index and that
this strategy has been effective. The active part of the equity portfolio will be
maintained as it is until the spectrum of managers has been thoroughly examined.

13. **INVESTMENT CONSULTANT REVIEW OF UC FOUNDATIONS INVESTMENT POLICIES**

[Background material was mailed to the Committee in advance of the meeting, and copies are on file in the Office of the Secretary and Chief of Staff.]

(For discussion see Item 14, below)

14. **INVESTMENT CONSULTANT REVIEW OF UC FOUNDATIONS FOURTH QUARTER 2007 PERFORMANCE REPORT**

[Background material was mailed to the Committee in advance of the meeting, and copies are on file in the Office of the Secretary and Chief of Staff.]

Richards & Tierney representative Ann Posey explained that Richards & Tierney was asked, as general investment consultant to the Regents, to review the campus foundations’ investment policies to ensure consistency with best practices. Richards & Tierney reviewed all the investment policies and procedures and compared them to the General Endowment Pool (GEP) documentation as a standard of best practices and found that all the campus foundation documents it received are consistent with best practices. Richards & Tierney has provided recommendations to each campus foundation and compiled a book-length document of all the policies it reviewed. Ms. Posey recommended that this compilation be reviewed regularly and distributed to all the foundations.

Ms. Posey then discussed some additional recommendations. In the latest Quarterly Investment Performance and Asset Allocation report for the foundations, six of the foundations were found to be not in compliance with the Regents’ asset allocation guidelines. Richards & Tierney recommends an exemption, based on its review, which found that the investment policies of these six foundations are consistent with industry best practices.

Committee Chair Wachter asked if the asset allocation ranges of these foundations were outside ±10 percent of these ranges. Ms. Posey recalled that the ranges have become narrower since the time of the last review, and stated that the Regents’ guidelines do not take account of how far allocations may be outside the ranges.

Committee Chair Wachter asked if any of the foundations were very far outside the ranges. Ms. Posey responded that the Quarterly Investment Performance and Asset Allocation report for the campus foundations provides detail for each foundation.
Ms. Posey further recommended that this report be distributed to all the foundations, for open communication and an open reporting process. She observed that this reporting process is relatively new; it is only in the last year that Richards & Tierney has compiled this information. There are opportunities to improve implementation of this reporting.

Ms. Posey noted that the Regents’ policy has asset allocation targets and ranges for high level asset categories, such as public equity, public fixed income, alternative investments, and liquidity. Richards & Tierney suggests that each foundation, based on its investment policies, provide a more detailed categorization, similar to that of the GEP, and report this to the Regents. Richards & Tierney also recommends that the report be provided to the foundations in advance to allow them to sign off on the asset allocation policy used in the report, before the report is presented.

Ms. Posey indicated that the last recommendation was the most important. Richards & Tierney supports the ongoing efforts to revise the existing Regents’ policy such that it will satisfy the Regents’ fiduciary responsibility but allow the foundations to manage their assets in a manner which is consistent with industry best practices and reflects their particular circumstances.

Committee Chair Wachter informed the Committee that he has asked Investment Advisory Group Consultant Hall to examine this campus foundation issue and to develop a solution that will be acceptable to all parties.

In response to a question asked by Committee Chair Wachter, Chief Investment Officer Berggren stated that the Committee on Investments must approve exceptions to the asset allocation policy. Committee Chair Wachter noted that this might involve UCLA, UC Berkeley, and UC San Francisco. Ms. Posey observed that the Santa Barbara campus is in transition; it was previously completely within the GEP guidelines. Committee Chair Wachter commented on some aspects of the UC Santa Barbara Foundation portfolio and noted that the UCLA and UCSB Foundations are developing in different directions.

Committee Chair Wachter discussed the variety of approaches the different campus foundations might take and the latitude that should be allowed, and expressed the hope that, in the future, it will become clearer when it would be appropriate for the Regents’ investment consultant or the Committee to disapprove of a foundation policy or action.

Regent Brewer stated that investment policies of the campus foundations should be consistent with best practices and that reviews should be carried out to ensure that foundations follow these policies.

In response to a question asked by Committee Chair Wachter, Ms. Berggren confirmed that campus foundation investment policies include asset allocation...
targets and guidelines. Ms. Posey confirmed that this is also the case for UCLA’s policy, which she described as extensive. She clarified that Richards & Tierney was interested in finding out who the responsible parties and decision-makers are, what a campus foundation’s asset allocation is, and what process was used to arrive at that asset allocation.

Committee Chair Wachter presented a hypothetical situation in which one campus might take a very conservative, risk-averse approach, while another campus was more aggressive in its allocations. He asked if this would be acceptable, as long as both campuses followed a proper asset allocation process. Ms. Posey described this scenario as one of extremes. She emphasized the importance for campus foundations to document their decision-making process and to explain the rationale for the risks they are taking, the ultimate use of their earnings, and the relationship of risk and return. She suggested that, if campus foundations work through this process, they may come to different conclusions in the future.

Investment Advisory Group member Martin opined that, if any campus foundation showed an extreme lack of asset diversification, this should give rise to discussion. Committee Chair Wachter observed that the University’s portfolio lacked diversification five years ago. At that time, this was not considered irresponsible, but simply a conservative portfolio based on a belief in risk reduction. He stressed the importance of the Regents’ fiduciary duty and of the review by the Regents’ investment consultant.

Ms. Posey observed that current policy focuses on asset targets and ranges. Richards & Tierney’s point of view is that this is one part of a larger picture to be observed. She stressed that the most important part of the Regents’ fiduciary oversight concerns governance, policies, discussions, and process. Richards & Tierney advocates a shift in emphasis from targets and ranges to policies, procedures, and governance. She noted that these areas are more difficult to review, while it is easy to draw conclusions from ranges.

Faculty Representative Croughan observed that, when the University’s allocations are outside of a documented target range, this creates publicity, even if the allocation is appropriate. She suggested that it might be advisable for the University to revise its guidelines. Ms. Berggren noted the effects of narrowing ranges for the University and campus foundations. Committee Chair Wachter stated that the policy needs to be reconsidered. It was never the intent of the policy to impose narrower ranges on the foundations than apply for the University.

Committee Chair Wachter and Ms. Berggren noted the importance of the investment consultant’s responsibility for alerting the Regents of any situation that appears inappropriate or extreme, concerning the portfolio, policies and practices, or governance.
In response to a suggestion made by Regent Brewer, Committee Chair Wachter proposed that an action item regarding an exemption for the campus foundations in question might be presented at the next meeting.

The meeting adjourned at 4:10 p.m.

Attest:

Secretary and Chief of Staff
The purpose for these performance objectives (“Objectives”) and management guidelines (Guidelines”) is to clearly state the investment approach, define performance objectives and to control risk in the management of the University’s Total Return Investment Pool, or TRIP (“Program”). These Objectives and Guidelines shall be subject to ongoing review by the Committee on Investments. Capital market conditions, changes in the investment industry, new financial instruments, or a change in the Committee on Investments’ risk tolerance, are among factors to be considered in determining whether the Guidelines shall be revised.

1. Investment Policy

a. Background:
The TRIP is an investment pool established by The Regents and is available to UC Campuses and the UC Office of the President. The TRIP allows Campuses to maximize return on their long-term working capital, subject to an acceptable level of risk, by taking advantage of the economies of scale of investing in a larger pool and investing across a broad range of asset classes.

b. Incorporation of Regents Investment Policies
   1. Investment governance, philosophy, policies and oversight procedures for this Program will be similar to those for the University of California Retirement Plan (UCRP) and General Endowment Pool (GEP), as specified in the Investment Policies for the UCRP.
   2. Relevant policies from Sections 1-3 of the UCRP Investment Policy Statement are incorporated by reference into this Policy.

c. Investment Objective
   The Objective of the Program is to generate a rate of return, after all costs and fees, in excess of the policy benchmark, and consistent with liquidity, cash flow requirements, and risk budget. See Section 2 for asset allocation and benchmark. As its name implies, TRIP is managed according to a total return objective, and will be subject to interest rate risk, credit risk, and equity risk. It is appropriate for longer-term investors who can accept this volatility in exchange for higher expected return.

d. Investment Strategy
   The Program shall be implemented by the Treasurer’s Office, using a combination of internal and external management (“Managers”), employing actively managed strategies where appropriate. Active strategies will include both sector allocation and security selection. The Treasurer will monitor the Program’s adherence to these Guidelines.

e. Risk Objective
   The Program shall be managed so that its annualized tracking error budget shall be 300 basis points. This budget is consistent with the ±10% ranges around the combined asset classes
(see 2a below), and incorporates both sector allocation and security selection differences from the aggregate benchmark.

Each Manager or asset class segment will have a unique active risk budget, relative to its asset class benchmark, which is appropriate to its individual strategy, and specified in its guidelines, and which will reflect the risk-return profile of its specific investment objectives.

f. Other Constraints and Considerations

- Managers shall comply with applicable State and Federal laws and regulations
- Managers shall at all times act with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims
- Managers shall act solely in the interest of the Program’s owners.

2. Investment Guidelines

The portfolio will be invested primarily in marketable, publicly traded equity and fixed income securities denominated in (or hedged back to) U.S. dollars.

a. Strategic Asset Allocation and Allowable Ranges

<table>
<thead>
<tr>
<th>Target Allocation</th>
<th>Minimum</th>
<th>Maximum</th>
</tr>
</thead>
<tbody>
<tr>
<td>Public Equity</td>
<td>25%</td>
<td>15%</td>
</tr>
<tr>
<td>US Fixed Income</td>
<td>75%</td>
<td>65%</td>
</tr>
<tr>
<td>Liquidity</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>Total</td>
<td>100%</td>
<td></td>
</tr>
</tbody>
</table>
b. Total TRIP Performance Benchmark

This is the composition of the total TRIP performance benchmark:

<table>
<thead>
<tr>
<th>Percentage</th>
<th>Benchmark</th>
</tr>
</thead>
<tbody>
<tr>
<td>10%</td>
<td>× Lehman Aggregate Government Index</td>
</tr>
<tr>
<td>45%</td>
<td>× Lehman Aggregate Credit Index</td>
</tr>
<tr>
<td>10%</td>
<td>× Lehman Aggregate Securitized Index</td>
</tr>
<tr>
<td>10%</td>
<td>× Merrill Lynch HY Cash Pay Index</td>
</tr>
<tr>
<td>10%</td>
<td>× Russell 1000 Index (Tobacco Free)</td>
</tr>
<tr>
<td>5%</td>
<td>× Russell 2000 Index (Tobacco Free)</td>
</tr>
<tr>
<td>10%</td>
<td>× MSCI World ex US Net Index (hedged) (Tobacco Free)</td>
</tr>
</tbody>
</table>

Notes on Total Program benchmark:
1. The calculation of the Total Program benchmark will assume a monthly rebalancing methodology.
2. In the event of a significant change in asset allocation, The Regents’ generalist consultant may specify an alternative weighting scheme to be used during a transition period.

c. Rebalancing Policy

There will be periodic deviations in actual asset weights from the policy asset weights specified above. Causes for periodic deviations are market movements, cash flows, and varying portfolio performance. Significant movements from the asset class policy weights will alter the intended expected return and risk of the Fund. Accordingly, the Investment Committee authorizes the Treasurer to rebalance the Fund when necessary to ensure adherence to the Investment Policy.

The Treasurer will monitor the actual asset allocation at least monthly. The Committee directs the Treasurer to take all actions necessary, within the requirement to act prudently, to rebalance assets to within the policy ranges in a timely and cost effective manner when actual weights are outside the prescribed ranges. The Treasurer may utilize derivative contracts (in accordance with the Derivatives Policy found in Appendix 4 of the UCRP Policy Statement) to rebalance the portfolio.

The Treasurer shall assess and manage the trade-off between the cost of rebalancing and the active risk associated with the deviation from policy asset weights. With approval from the Chair of the Committee, the Treasurer may delay a rebalancing program when the Treasurer believes the delay is in the best interest of the Plan. Results of rebalancing will be reported to the Committee at quarterly meetings.

d. Asset Class Guidelines

The Program will be invested in a diversified portfolio of equity and fixed income securities. Each Segment of the Program, as defined above, will be subject to the Regents Asset Class guidelines that is appropriate and in effect for that Segment. These Guidelines are found in the Appendices to the UC Retirement Plan Investment Policies, and are hereby incorporated by reference.
e. Restrictions
The Managers may **not:**
- Purchase securities of tobacco related companies, as per the UCRP Investment Policy, section 5b.
- Invest in mutual funds or group trusts unless specifically allowed in its guidelines.
- Buy party-in-interest securities.
- Buy securities restricted as to sale or transfer, except for 144A securities, which are permitted.
- Buy or write structured (“levered”) notes.
- Employ economic leverage in the portfolio through borrowing or derivatives, or engage in derivative strategies that conflict with the Derivatives Policy.

Subject to the limitations above, the Managers have complete discretion with regard to choosing sector weights, issuers, and maturities.

3. Evaluation and Review
a. Policy and Guideline Review
The Treasurer’s Office shall review the Objectives and Guidelines at least annually, and report to the Committee on Investments on the impact of the Guidelines on the Program’s performance.

b. Program performance and risk exposures shall be evaluated at multiple levels in accordance with the Objectives of the Program and individual Managers.

4. Reporting
On a quarterly basis, the Treasurer’s Office shall provide the following reports to the Committee on Investments:

a. A summary of Program investments and risks.

b. A summary of Program performance, on an absolute and benchmark relative basis.

Each Manager will be required to provide the Treasurer monthly and quarterly reports, including but not limited to:

- Monthly accounting statements showing portfolio income, holdings and transactions
- Quarterly review of portfolio and strategy performance including a market outlook
- Annual statement of compliance with investment guidelines

5. Investment Operations and Restrictions
a. University Financial Management may establish limitations on Campus investments to maintain sufficient short term liquidity for University cash needs, and restrictions on withdrawals as is appropriate for the investment of longer-term assets.
b. Annual distributions of income and capital gains will be made to participating Campuses, according to a spending rate will be reviewed and approved annually by the Committee on Investments.

6. Definitions: See Appendix 8 of the UCRP Policy Statement
# Treasurer's Office Annual Incentive Plan (AIP)
## Performance Objectives for FY 2008-09

<table>
<thead>
<tr>
<th>ENTITY</th>
<th>UC TREASURERS OFFICE</th>
<th>Benchmark</th>
<th>Threshold</th>
<th>Target</th>
<th>Maximum</th>
</tr>
</thead>
<tbody>
<tr>
<td>GEP, UCRP, UCRSP, STIP &amp; HIP</td>
<td>Asset Weighted Policy Benchmark</td>
<td>5 bp</td>
<td>30 bp</td>
<td>70 bp</td>
<td></td>
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</table>

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Benchmark</th>
<th>Threshold</th>
<th>Target</th>
<th>Maximum</th>
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</thead>
<tbody>
<tr>
<td><strong>Public Equity</strong></td>
<td>Asset Weighted Policy Benchmark (Equity)</td>
<td>15 bp</td>
<td>80 bp</td>
<td>170 bp</td>
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<td><strong>Private Equity</strong></td>
<td>Venture Economics Vintage Year Indices</td>
<td>50 bp</td>
<td>100 bp</td>
<td>200 bp</td>
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<tr>
<td><strong>Fixed Income</strong></td>
<td>Asset Weighted Policy Benchmark (Fixed Income)</td>
<td>5 bp</td>
<td>40 bp</td>
<td>80 bp</td>
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<tr>
<td><strong>Absolute Return</strong></td>
<td>US 1-month Treasury Notes + 450 bps</td>
<td>10 bp</td>
<td>65 bp</td>
<td>130 bp</td>
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<tr>
<td><strong>403b ICC Fund</strong></td>
<td>US 5-year Treasury Notes Income Return</td>
<td>5 bp</td>
<td>30 bp</td>
<td>60 bp</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Sector</th>
<th>Benchmark</th>
<th>Threshold</th>
<th>Target</th>
<th>Maximum</th>
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</thead>
<tbody>
<tr>
<td><strong>Income Funds</strong></td>
<td>US 2-year Treasury Notes Income Return</td>
<td>5 bp</td>
<td>30 bp</td>
<td>60 bp</td>
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<tr>
<td><strong>Fixed Income Government Sector</strong></td>
<td>Tracking Error of Monthly Returns (annualized)</td>
<td>35 bp</td>
<td>25 bp</td>
<td>15 bp</td>
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<tr>
<td><strong>Fixed Income Collateral Sector</strong></td>
<td>Collateral Sector of Citigroup Large Pension Fund</td>
<td>5 bp</td>
<td>30 bp</td>
<td>60 bp</td>
</tr>
<tr>
<td><strong>Fixed Income Credit Sector</strong></td>
<td>Credit Sector of Lehman Aggregate</td>
<td>5 bp</td>
<td>30 bp</td>
<td>60 bp</td>
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<tr>
<td><strong>Reference</strong></td>
<td>Russell 3000 Tobacco-Free Index</td>
<td>15 bp</td>
<td>75 bp</td>
<td>150 bp</td>
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<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Benchmark</th>
<th>Threshold</th>
<th>Target</th>
<th>Maximum</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>High Yield Bonds - UCRP</strong></td>
<td>ML High Yield Cash Pay Index</td>
<td>12 bp</td>
<td>65 bp</td>
<td>130 bp</td>
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<tr>
<td><strong>Global Equity</strong></td>
<td>MSCI World Net Tobacco Free Index</td>
<td>15 bp</td>
<td>85 bp</td>
<td>170 bp</td>
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<tr>
<td><strong>Bonds - UCRP</strong></td>
<td>Citigroup Large Pension Fund [LPF]</td>
<td>5 bp</td>
<td>50 bp</td>
<td>100 bp</td>
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<tr>
<td><strong>Bonds - GEP</strong></td>
<td>Custom Benchmark [Citigroup LPF + Lehman Agg]</td>
<td>5 bp</td>
<td>30 bp</td>
<td>60 bp</td>
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<tr>
<td><strong>403(b) Bonds</strong></td>
<td>Lehman Brothers Aggregate</td>
<td>5 bp</td>
<td>30 bp</td>
<td>60 bp</td>
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# Treasurer's Office AIP FY 2008-2009 Participants and Weightings

## Revised as of April 2008

### Selection & Weighting of Performance Measures

<table>
<thead>
<tr>
<th>Position</th>
<th>Incumbent</th>
<th>Threshold</th>
<th>Target</th>
<th>Maximum</th>
<th>Entity</th>
<th>Funct. Gp</th>
<th>Sector</th>
<th>Discret.</th>
<th>Asset Class/Sector Objectives</th>
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</thead>
<tbody>
<tr>
<td><strong>Senior Management Group</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Chief Investment Officer</td>
<td>Marie Berggren</td>
<td>50%</td>
<td>100%</td>
<td>165%</td>
<td>75%</td>
<td>0%</td>
<td>0%</td>
<td>25%</td>
<td>15% = Five Year Treasury Income Return</td>
</tr>
<tr>
<td>Asst. Treasurer</td>
<td>Melvin Stanton</td>
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<td>60%</td>
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<td>25%</td>
<td>60% = wtd. avg. of all fixed income assets</td>
</tr>
<tr>
<td>MD, Fixed Income</td>
<td>Randall Weddell</td>
<td>25%</td>
<td>60%</td>
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<td>60%</td>
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<td>60% = wtd. avg. of all actively managed equity assets</td>
</tr>
<tr>
<td>MD, External Invest.</td>
<td>William Caeker</td>
<td>25%</td>
<td>60%</td>
<td>120%</td>
<td>60%</td>
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<td>60% = wtd. avg. of all alternative assets</td>
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<td>Vacant</td>
<td>25%</td>
<td>60%</td>
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<td></td>
</tr>
<tr>
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<td>Jesse Phillips</td>
<td>25%</td>
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<td>70%</td>
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<tr>
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<td>Linda Frie</td>
<td>20%</td>
<td>45%</td>
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<td>35%</td>
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<td>Sector weights based on avg mkt value of relevant portfolios</td>
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<td>Satish Swamy</td>
<td>20%</td>
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<td>David Schroeder</td>
<td>20%</td>
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<td>Jr. Portfolio Manager</td>
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<td>60% = T Bills + 450 bp</td>
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<td>60% = Weighted comb. of Core and Non-Core strategies</td>
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</tr>
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<td>Scott Nystrøm</td>
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<th>Recommended Award Opportunity</th>
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<tr>
<td>1% of Base Salary</td>
<td>$ 1,278,627</td>
<td>$ 2,844,075</td>
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Attachment III