The Regents of the University of California

COMMITTEE ON INVESTMENTS
INVESTMENT ADVISORY GROUP
June 22, 2011

The Committee on Investments and the Investment Advisory Group met jointly on the above date by teleconference at the following locations: 777 South California Avenue, Palo Alto; Morgan Center Press Room, Los Angeles campus; and 1111 Franklin Street, Room 9204, Oakland.

Members present: Representing the Committee on Investments: Regents Kieffer, Marcus, and Schilling; Staff Advisors Herbert and Martinez

Representing the Investment Advisory Group: Members Martin, Rogers, Samuels, and Chief Financial Officer Taylor; Consultant Klosterman

In attendance: Associate Secretary Shaw, General Counsel Robinson, Chief Investment Officer Berggren, and Recording Secretary McCarthy

The meeting convened at 1:35 p.m. with Committee Vice Chair Marcus presiding.

1. **PUBLIC COMMENT SESSION**

There were no speakers wishing to address the Committee.

2. **APPROVAL OF MINUTES OF PREVIOUS MEETING**

Committee Vice Chair Marcus explained that, due to the lack of a quorum, action on this item would be deferred to the July 2011 meeting.

3. **FIRST QUARTER 2011 AND FISCAL YEAR TO DATE INVESTMENT PERFORMANCE SUMMARY**

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

Chief Investment Officer Berggren reported that all portfolios had excellent absolute and relative returns in the first quarter of 2011. The UC Entity, comprised of all assets managed by the Treasurer's Office, rose 3.09 percent in the quarter; the University of California Retirement Plan (UCRP) rose 3.81 percent; the General Endowment Pool (GEP) rose 3.43 percent; the Short Term Investment Pool (STIP) rose 55 basis points (bps); the Total Return Investment Pool (TRIP) rose 1.94 percent. Performance benefited from asset selection in absolute return and core fixed income; real estate and equities were the best performing asset classes.

Ms. Berggren pointed out that GEP performance ranked in the top third of the Cambridge Associates' peer universe and UCRP returns ranked in the top quartile of public funds as measured by the Wilshire Trust Universe Comparison Service (TUCS) universe.

Investment Advisory Group member Rogers asked for an update regarding the discussion at the prior Committee meeting about which comparator group was appropriate for the University to use. Ms. Berggren responded that there were two choices, the Cambridge Associates' peer universe or the Wilshire TUCS universe, and cautioned that performance information was not audited. Mr. Rogers stated that the median fund value in the Cambridge universe was only about $500 million. Ms. Berggren stated that her office used only the large endowments within the Cambridge Associates' universe, not all the funds. Mr. Rogers asked Ms. Berggren to send him a copy of the large endowment index.

Turning to an overview of the market, Ms. Berggren stated that global equities advanced in the quarter, reflecting investors' confidence that the Federal Reserve Board would continue its policies supporting economic growth. Fixed income held its own, despite concern about possible high inflation and accelerating growth. Emerging markets as a group trailed developed markets, as concerns about inflation reduced demand for emerging market securities. The Russell 3000 Index gained 6.4 percent for the quarter and 32.4 percent year-to-date. The MSCI World ex-U.S. rose 3.8 percent for the quarter and 29.2 percent year-to-date; emerging markets gained 29.3 year-to-date. As a result of economic improvement, fixed income investments had lower returns than did the equity market.

Ms. Berggren discussed recent performance of UC funds. All funds delivered very strong returns for both the quarter and recent six-month period. Security selection, strategy selection, and manager performance in absolute returns were major contributors. UCRP, GEP, and the UC Entity all outperformed their policy benchmarks. UCRP rose 3.8 percent for the quarter and GEP rose 3.4 percent, resulting in a 3.1 percent gain for the UC Entity. In the past nine months, UCRP rose 20.6 percent, GEP rose 19 percent, and the UC Entity was up 16.1 percent.

In the longer term, returns have been very strong over the past two years, resulting in improving returns over all time periods. Three-year returns were 200 bps higher than those reported last December. UCRP has outperformed its policy benchmark in 75 percent of the past 20 years.

Turning to performance of UCRP asset classes, Ms. Berggren stated that UCRP global equities had very strong gains for the quarter. Low inflation, gross domestic product growth, and positive corporate earnings were contributing factors. Fixed income was flat and Treasury Inflation-Protected Securities (TIPS) were up only two percent. Private equity and real estate continued their good gains of the prior quarter. For the calendar year-to-date, U.S. equity, international developed equity, and emerging market equity were the best-performing asset classes.

Ms. Berggren provided an update on asset allocation. UCRP had a slight overweight in U.S. equity, private equity, and absolute return strategies, and a corresponding underweight in core fixed income and TIPS. GEP was overweight in U.S. equity and private equity, and underweight in TIPS.

Performance attribution by asset class in UCRP showed that core bonds added 17 bps to active performance; TIPS added six bps; absolute return strategies added 34 bps. Asset selection contributed 36 bps to active performance. In sum, UCRP had very good excess returns for the quarter. In the GEP, TIPS added six bps and absolute return strategies had a particularly strong quarter. Total active return in the GEP was 137 bps for the nine month period ending March 31, 2011.

Discussing risk in UCRP, Ms. Berggren stated that public equity contributed over 75 percent of total risk. All active risk was attributable to overweight in U.S. equity and private equity. In GEP, public equity and absolute return strategies contributed almost all the total risk; U.S. equity and private equity accounted for all the active risk.

4. **ADOPTION OF POLICY ON DISCLOSURES REGARDING USE OF PLACEMENT AGENTS FOR THE UNIVERSITY OF CALIFORNIA RETIREMENT SYSTEM INVESTMENTS**

The Chief Investment Officer and the President recommended that the Policy on Disclosures Regarding Use of Placement Agents for the University of California Retirement System Investments, as shown in Attachment 1, for private partnership investments be adopted.

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Chief Investment Officer Berggren explained that the California Legislature had adopted two bills, AB 1584, requiring California pension funds to have a policy that addresses the use of placement agents, and AB 1743, requiring that placement agents register as lobbyists with the State. Ms. Berggren pointed out that while the Regents have broad autonomy to establish rules, they have chosen independently to adopt these policies for the sake of transparency. Investment managers will be required to confirm in writing that they are aware of this policy.

Committee Vice Chair Marcus explained that, due to the lack of a quorum, action on this item would be deferred to the July 2011 meeting.

5. **ADOPTION OF EXPENDITURE RATE FOR TOTAL RETURN INVESTMENT POOL**

The Chief Investment Officer recommended and Mercer Investment Consulting concurred that the expenditure rate (payout rate) for the Total Return Investment Pool for the fiscal year 2010-11 be set at a maximum of six percent.

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Chief Investment Officer Berggren stated that each year a payout rate is set for the Total Return Investment Pool (TRIP). TRIP was developed about three years ago, with funds from the Short Term Investment Pool (STIP) appropriate for longer-term working capital with slightly higher returns and risk. When the asset class was established, the recommended payout rate was set at six percent, consistent with the long-term return of TRIP.

In response to a question from Regent Schilling, Ms. Berggren stated that the payout rate for TRIP is set every year, based on performance.

Committee Vice Chair Marcus explained that, due to the lack of a quorum, action on this item would be deferred to the July 2011 meeting.

6. **SECURITIES LENDING PROGRAM REVIEW**

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

Associate Chief Investment Officer Melvin Stanton reported that the Office of the Treasurer’s Securities Lending Program had $17.5 billion out on loan as of March 31, 2011. The program uses State Street Bank as its custodial agent and lending agent, and State Street Global Advisors as its collateral manager.

Mr. Stanton explained that securities lending refers to transactions in which the owner of securities lends the securities to a borrower in exchange for collateral consisting usually of cash, but in some cases securities. The cash collateral ranges from 102 percent to 105 percent of the value of the securities, and is adjusted daily as the market value of the underlying securities changes. The borrowers are typically large banks, hedge funds, or brokers who use the securities to facilitate day-to-day market making, arbitrage, or risk management strategies, or to cover short sales. Incremental income is generated for the securities’ lender by investment of the cash collateral in high quality, short-term investments, with the income split between the securities’ owner and the lending agent. The objective of securities lending is to generate consistent incremental income from the collateral while maintaining safety of principal and minimizing risk.

Mr. Stanton displayed a chart showing earnings by asset class since 1999 in the Securities Lending Program. The largest producer of securities lending income was the U.S. equity portfolio, followed by U.S. Treasuries, U.S. agencies, and non-U.S. equities. Mr. Stanton reported that a substantial amount of incremental return was being generated from the portfolio.

Turning to risk in the Securities Lending Program, Mr. Stanton stated that there was the risk that the borrower could default and be unable to return the securities at the end of the term of the loan. However, since State Street Bank and Trust Company indemnifies the UC system against this risk, this type of risk is not a concern. Operational risk, meaning the risk of a failure of operational procedures, such as wire system failure, has been very rare.

Investment Advisory Group consultant Klosterman noted that there were issues of the value of collateral in securities lending during the 2008 financial crisis. He asked if UC had any such problems at that time. Mr. Stanton responded in the negative, and stated that such risk would be included in investment or credit risk, or the risk of default on collateral investment assets. He stated that UC had no defaults on any of its investments, although it did have some impaired pricing during that time period. Mr. Stanton added that the cash generated from the Securities Lending Program was invested in a separate account at State Street Bank and managed with guidelines approved by the Regents.

Mr. Klosterman asked if State Street Bank and Trust Company indemnified only UC risk, or other institutions' risk as well. Mr. Stanton responded that State Street indemnified most of its major clients. When asked by Mr. Klosterman if State Street Bank and Trust was capable of standing behind such indemnification, Mr. Stanton responded in the affirmative, based on State Street's balance sheet, and asserted that State Street Bank and Trust also looked to the underlying collateral. He pointed out that, even in the very unusual event of Lehmann Brothers' bankruptcy, UC had no losses in its Securities Lending Program. Chief Investment Officer Berggren added that the Office of the Treasurer, contrary to most institutions, actively managed its risk by carefully examining each credit and was intentionally very conservative in its Securities Lending Program. Mr. Stanton pointed out that the Office of the Treasurer has its own credit team dedicated to examining the credits purchased in the Securities Lending Program, as well as in UC's larger portfolio. Ms. Berggren stated that UC was one of the few institutions that had no problems in its Securities Lending Program during the recent financial crisis.

Chief Financial Officer Taylor stated that Executive Vice President Brostrom and he had discussed with Ms. Berggren and Senior Managing Director Randy Wedding the possibility of changing the Securities Lending Program slightly to stop lending U.S. Treasury bonds and U.S. Agency bonds from the Short Term Investment Pool (STIP). He noted that UC's liquidity in STIP had been under pressure recently as Moody's and Standard and Poor's discounted any Treasuries that had been lent out by 100 percent. Moody's informed the University the past week that they were reviewing UC's rating in part because of this liquidity ratio. Additionally, Mr. Taylor stated that the University would like to move more money from STIP into the Total Return Investment Pool (TRIP). Campuses have noticed TRIP's good returns under the direction of Ms. Berggren and her team. Committee Vice Chair Marcus asked if this issue would come before the Committee on Investments, to which Ms. Berggren responded that it was not a Committee issue.

Mr. Stanton stated that there was also interest rate risk, since the Securities Lending Program put out loans on an overnight basis and invested in slightly longer securities. If short term rates should rise, a negative return on some investments could result. His staff actively monitored interest rate risk and currently kept investment durations very short.

7. **PUBLIC EQUITY PROGRAM REVIEW**

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

Senior Managing Director William Coaker stated that the current investment strategy of the U.S. equity portfolio was to increase active risk in the small cap segment and to decrease active risk in the large cap segment. Additionally, Mr. Coaker stated that he intends to increase use of investment managers who are more focused in fewer products and whose funds have modest asset size, and those with specialty or niche strategies. Current investment strategy was also to increase active share and tracking error. Mr. Coaker stated that the strategy for the U.S. equity portfolio was to emphasize the use of managers with high conviction portfolios and eliminate over-diversification. Mr. Coaker advised that he would seek extra exposure to emerging markets through U.S. companies that do more business in emerging markets, since 70 percent of global growth currently was in emerging markets.

Turning to the international equity portfolio, Mr. Coaker stated that his strategy was to have extra exposure to a variety of emerging market themes, including a wide array of consumer areas such as retail, consumer discretionary, consumer staples, health care, financial services, and infrastructure. He also intended to tilt the portfolio toward higher quality companies because of the low economic growth and high levels of debt in Europe and Japan. Mr. Coaker advised that his strategy was to have a satisfactory level of active share and tracking error. The international equity portfolio would emphasize managers with the highest conviction and move toward elimination of over-diversification when the portfolio was considered as a whole. The number of outside managers for this portfolio had been reduced from 12 to ten, and would be reduced further to nine.

Regarding the emerging markets equity portfolio, Mr. Coaker stated that his investment strategy was to increase exposure to companies doing more business in their own countries or other emerging market countries, rather than companies exporting to the United States or Europe. The emerging markets equity portfolio would also emphasize a broad array of emerging market consumer and infrastructure themes, increase active share and tracking error, emphasize highest conviction managers, eliminate over-diversification, and use managers with specialty or niche strategies.

Mr. Coaker summarized active public equity returns. In fiscal year (FY) 2009, U.S. equity outperformed its benchmark by 70 basis points (bps), international equity outperformed its benchmark by 160 bps, emerging markets lagged its benchmark by 90 bps, and the total public equity portfolio outperformed its benchmark by 74 bps. In FY 2010, U.S. equity underperformed its benchmark by 33 bps, international equity outperformed its benchmark by 321 bps, emerging markets outperformed its benchmark by 281 bps, and the composite public equity portfolio outperformed its benchmark by 159 bps. While absolute returns in the current fiscal year have been excellent, relative returns have been more challenging. The U.S. equity portfolio has underperformed its benchmark by 129 bps, international equity and emerging markets are very close to their benchmarks, and the total public equity portfolio has underperformed its benchmark by 50 bps as of June 8, 2011. Currently, the total portfolio trails its benchmark by only 37 bps, largely because of improvement in the emerging markets portfolio.

Mr. Coaker noted that, in calendar year 2009 returns were unusually good, as the U.S. equity portfolio outperformed its benchmark by 5.3 percent. He expressed his opinion that this performance was related to the extreme selloff in 2008, which created bargains in 2009. However, since January 2010, the U.S. equity portfolio has underperformed relative to its benchmark. Mr. Coaker stated that high risk, low-quality stocks led the market rally, and that such stocks typically give way to lower risk, higher quality stocks as a rally continues, but that this transition had not taken place in the current market until very recently. He expressed his opinion that the U.S. equity portfolio was currently well-positioned going forward, as high risk, low-quality stocks appeared to be overvalued. Additionally, there had been a high correlation among stocks in 2010 and early 2011, meaning that all stocks generally moved in the same direction. There had been a series of market moves relating to investors' general increased appetite for risk, or, on the other hand, general reduced risk tolerance. However, Mr. Coaker stated that the correlation among stocks had begun to decline in the past two months.

Analyzing the active return in international equity, Mr. Coaker pointed out the portfolio's strong performance relative to the benchmark in FY 2009 and FY 2010, but noted that returns had just equaled the benchmark thus far in FY 2011. He stated that the performance improved recently, as the portfolio had lagged the benchmark by two percent four months ago. He stated his opinion that investors' appetite for risk was deteriorating, as managers were more cognizant of economic risks. Stock returns had significantly outperformed the improvement in developed market economies.

Mr. Coaker reported that the emerging markets equity portfolio underperformed its benchmark in FY 2009 and strongly outperformed its benchmark in FY 2010. In FY 2011 to date, the portfolio was slightly outperforming its benchmark, by 50 bps. He stated that active return had been more muted in the current year because of an increase in valuation; emerging market stocks were not as attractively valued as they had been two years ago and managers were more aware of current economic risks.

In summary, Mr. Coaker stated that overall stock returns in developed markets have significantly outpaced economic improvement in the past two years. During that period, individual stock returns had been related to investors' general sentiment toward risk, rather than the financial performance of specific companies. Mr. Coaker expressed his opinion that, over the longer term, individual stock performance would be the driver of returns.

Turning to future plans, Mr. Coaker stated that he had high expectations for his office's initiative to use traditional hedge fund managers for a long-only mandate in the U.S. equity portfolio. He planned to increase the use of active management in small cap stocks and to decrease active management in large cap stocks, since there were twice as many small cap stocks as large cap, and the small cap stocks were much less covered by analysts. In response to a question from Committee Vice Chair Marcus, Managing Director Jesse Phillips clarified that small cap stocks were the smallest 2,000 stocks in the Russell 2000 Index, up to approximately a $1.9 billion market capitalization. Mr. Coaker stated that his office intended to increase its use of managers focused on fewer strategies and with modest levels of assets, enabling them to be more nimble than managers of larger funds.

Committee Vice Chair Marcus asked on what basis hedge fund managers were paid. Chief Investment Officer Berggren replied that her office had a separate hedge fund asset class. She stated that in the U.S. equity portfolio the only hedge fund was a portfolio of the long only portion of a fund comprised of funds of individual hedge fund managers. Mr. Coaker pointed out that, since this hedge fund portion was long only, the fee structure would be materially different from that of the typical hedge fund and would have satisfactory transparency. Mr. Phillips stated that the Office of the Treasurer did consider fee structures when selecting managers.

In response to a question from Regent Schilling, Mr. Coaker stated that his plan was to increase small cap stocks in the active portion of the portfolio, and underweight small cap stocks in the passive portion. Ms. Berggren explained that the fund would still have the same weight of small and large cap stocks as the index, but her office would increase the active management of the small cap component. Mr. Coaker stated that about $1.3 billion would be allocated to such management when the program was fully implemented.

Ms. Berggren stated that Mr. Coaker had chosen excellent managers with unique investing styles who have performed well over time. Mr. Coaker said that he searched for managers less commonly used by other large institutions and emphasized that his office exercised due diligence in its examination of managers.

Investment Advisory Group member Martin asked for the proportion of active and passive investments in the public equity portfolio. He also asked how the passive portion of the portfolio was managed. Mr. Coaker responded that the active portion was 30 percent of the portfolio and the passive portion was 70 percent. Mr. Phillips stated that the passive portion was a separately managed portfolio of the stocks in the Russell 3000 Tobacco Free Index.

Mr. Martin asked about Mr. Coaker's approach to the international equity portfolio, specifically regarding the current environment for the Eurozone and Japan. Mr. Coaker noted that the fund currently had a tilt toward higher quality companies that had more sustainable sales and earnings, and less sensitivity to the overall economy. The international equity portfolio currently had an underweight in financial stocks because of the suspect condition of European banks. Ms. Berggren added that the portfolio's carefully chosen managers were cognizant of these international issues. Mr. Coaker stated that his office recently hired a new manager whose portfolio had performed well in many different market conditions. While this manager's investments have been apt to underperform slightly in a strong beta rally, his fund had outperformed in the negative market of the prior few months. Mr. Coaker stated that his office was streamlining the international equity portfolio from 12 managers to nine.

Mr. Coaker explained that the term active share referred to that portion of a manager's portfolio that was different from the benchmark. For the overall portfolio, the active share referred to the composite of the active shares of the underlying portfolios. His office strived to ensure that the active share was high enough so that the composite of the portfolio was sufficiently different from its benchmark.

Turning to his action plan for the emerging markets equity portfolio, Mr. Coaker stated that his office planned to invest with several managers who focus solely on Brazil and China. He stated his opinion that managers with a narrow focus were better able to identify inflection points, earning points, secular trends, the impact of legislation, the political environment, and emerging companies better and earlier than were globally diversified managers. Mr. Coaker's office was completing due diligence on managers who focus on India or Russia, and would evaluate prospects for investing with regional managers in markets such as Asia, Latin America, Eastern Europe, Africa, or the Middle East. He was also evaluating the possibility of investing with managers who invest in frontier markets, which he defined as those smaller than emerging markets. Generally, his office intends to reduce the number of globally diversified managers.

Committee Vice Chair Marcus stated that, while the Regents were generally not involved in the details of international investing, they did have a sense of an appropriate level of risk.

8. **INVESTMENT CONSULTANT REVIEW OF UC CAMPUS FOUNDATIONS FOURTH QUARTER 2010 PERFORMANCE REPORTS**

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

Mr. Terry Dennison of Mercer Investment Consulting reported that his firm found no exceptions of note in its review of performance and asset allocation of the ten UC campus foundations. He noted that UC Santa Barbara's foundation continued to have an underweight in alternatives because of the time necessary to generate an alternatives portfolio, which indicated the foundation's conservative approach to developing the portfolio. The performance of all the campuses' foundations were in the second to third quartile, with the exception of the UC Riverside Foundation, which was in the first quartile as a result of its larger allocation to public equity.

The meeting adjourned at 2:15 p.m.

Attest:

Associate Secretary

Attachment 1

POLICY ON DISCLOSURES REGARDING USE OF PLACEMENT AGENTS FOR THE UNIVERSITY OF CALIFORNIA RETIREMENT SYSTEM INVESTMENTS

Each External Manager proposing an investment to be made by or on behalf of the University of California Retirement System must comply with one of the following two requirements:

(1) If the External Manager will not use any Placement Agents in connection with the proposed investment, the External Manager must provide the Treasurer with a written statement to that effect.

(2) If the External Manager will use a Placement Agent in connection with the proposed investment, the External Manager must disclose the following information in writing to the Treasurer:

- A description of the relationship between the External Manager and any Placement Agents for the investment for which funds are being raised.
- Whether the Placement Agent's mandate includes the Regents of University of California as trustee/custodian.
- A description of the services performed by the Placement Agent.
- A description of any and all payments of any kind provided or agreed to be provided to a Placement Agent by the External Manager with regard to investments by the Regents as a plan trustee or custodian of retirement or savings plan assets.
- Upon request, the resume for each officer, partner or principal of the Placement Agent detailing the person's education, professional designations, regulatory licenses, and investment and work experience.
- A statement as to whether the Placement Agent, or any of its affiliates, is registered with the Securities Exchange Commission.
- A statement as to whether the Placement Agent, or any of its affiliates, is registered as a lobbyist under California law.

The Treasurer will only enter into agreements to invest in or through External Managers that agree to comply with the Regents' Policy on Disclosures Regarding the Use of Placement Agents for University of California Retirement System Investments. The Treasurer will rely on the written statements made by the External Manager.

For purposes of this Policy:

“External Manager” means a (i) person who is seeking to be, or is, retained by the Regents to manage a portfolio of securities or other assets for compensation or (ii) a person managing an investment fund who offers or sells, or has offered or sold, an ownership interest in the investment fund.

“Placement Agent” means a person directly or indirectly hired, engaged or retained by, or serving for the benefit of or on behalf of, an External Manager or an investment fund managed by an External Manager, who acts, or has acted, for compensation as a finder, solicitor, marketer, consultant, broker or other intermediary in connection with the offer or sale to the Regents of either the investment management services of the External Manager or an ownership interest in an investment fund managed by the External Manager. Any exceptions to this definition of “Placement Agent” available under Sections 7513.8 or Section 82047.3 of the California Government Code will apply under this Policy.