Committee members present: David Neil (Chair), Mary Ellen Becker, Owen Newlin, Jenny Rokes, Rose Vasquez, President John Forsyth (ex officio)

Call to Order, Introductory Comments

INV 1. Minutes from September 14, 2004 Committee Meeting

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<th>MOTION</th>
<th>Regent Neil moved to approve the minutes of the September 14, 2004, Investment Committee meeting. Regent Rokes seconded the motion.</th>
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INV 2. Selection of Small Cap Fund Manager

Regent Neil said this particular item has two parts to it; one is the termination of Seneca Capital Management and then the selection of Artisan Partners as a new small cap domestic fund manager.

On Friday, November 19, 2004, representatives from the institutions, along with Regent Forsyth, Regent Newlin and Regent Neil interviewed three managers for that position. Cartwell Investment Partners, Mazama Capital Management and Artisan Partners. A recommendation was made to the Committee that Artisan Partners be selected. Wilshire, after the interviews, indicated they would try to negotiate a better fee.

Mark Friedberg from Wilshire said they tried to negotiate a better fee, but with this particular manager, Artisan, the product the Regents chose was a very limited asset class that was closed to business. Artisan would not lower their fee. They did agree to a most favored nations clause within the fee, which means nobody else will be paying a lower fee than the Board at the amount of assets being invested.
Regent Becker made a motion to terminate Seneca Capital and to select Artisan Partners as the new Small Cap Domestic Fund Manager. Regent Rokes seconded.

MOTION CARRIED UNANIMOUSLY

INV 3. Investment and Cash Management Report for the Quarter Ended September 30, 2004

Mark Brubaker from Wilshire reviewed the Investment and Cash Management report for the quarter ended 9/30/04 and provided an update of the current market as of 12/14/04.

The Dow Jones Wilshire 5000 was down the 3rd quarter, 1.8%, primarily due to concerns about GDP growth, as well as the uncertainty surrounding the situation in Iraq and the election. The S&P 500 followed suit, also down 1.9% for the quarter. International stocks were slightly positive, up 1%. Most of that incremental return over the U.S. Equity Markets is due to currency, the declining U.S. dollar, the depreciation of the Euro, the Yen, and the Pound relative to the dollar. Real estate, as measured by the Real Estate Securities Index was up 8.2% for the quarter. Going down to Fixed Income, Lehman Aggregate Bond, rebounded from disappointing early returns. The Fixed Income market in general was up 3.2%, as measured by that index. International bonds are up 3.3%. T-bills are up 0.4% and CPI remained in check.

The University of Iowa endowment was down 60 basis points for the quarter, versus -.2% for the policy index, so they trailed the policy index by 40 basis points. On year-to-date, they are behind by 1.3%. For the one year period, down 1.6%. Mr. Brubaker said that under-performance has resulted from the under-performance of the U.S. equity portfolio. That was primarily, if not entirely driven by Seneca’s under-performance. Over the past year, Seneca was more than 10% behind their benchmark. The U.S. equity portfolio was down over 2.5% behind its benchmark.

Looking at the longer term numbers, the three year number is 60 basis points ahead of the Regent policy index and for five years, the numbers look quite good, 5.6% versus 2.3%. Seneca’s early returns back in 1999 and early part of 2000 had a lot to do with that excess return for the longer term period.

The asset mix is more or less on policy. The University of Iowa endowment ended the quarter at $187 million in total assets.

Similar results occurred for the Iowa State University endowment. They are down 80 basis points for the quarter or - .8%, versus -.2% for the index, with a shortfall of 60 basis points. The ISU longer-term numbers are similar to the results for the University of Iowa for the same reason. The Iowa State University endowment ended at $116.2 million.

The Committee received the investment and cash management report for quarter ended September 30, 2004, by general consent.
INV 4. **Performance Review of Wilshire Associates**

Mark Friedburg discussed the depth of resources that Wilshire has to offer including the addition of several of additional resources in recent years. The consulting team that services the Board’s account has grown in size.

Mr. Friedburg highlighted the level of activities and due diligence Wilshire provided to the Regent Investment Committee as well as performance of the fund along with the risk comparisons.

Mr. Friedburg explained the Wilshire criteria that identifies best practices.

Regent Neil said it’s been a busy year and some dramatic changes have been made in the selection of new managers.

Mr. Friedburg agreed. Wilshire took a broad look at the overall structure of the Regent portfolio from the underlying managers.

From Wilshire’s point of view, March 31, 1996 is the inception of the Regent/Wilshire relationship. At the start, there were combined assets of $105 million, net capital flows were $25 million. A total investment gain over that eight-year period was $265 million, leaving assets at $396 million.

Regent Newlin asked if there are any assets added. Mr. Friedburg said the Principal IPO was the biggest addition, which was included under the net cash flows category of that $25 million. There were times when assets were a negative outflow, as shown with Iowa State University, having cash outlays of $50 million. The positive net cash flows for the University of Iowa endowment and quasi endowment were about $80 million. Regent Newlin questioned whether if $105 million compared to $400 million was really a net increase. Mr. Friedburg said the $265 million is the net gain.

Compared to a Greenwich Study of 2003 endowments and foundations, the Regent Investments are more conservative than its peers, particularly in the asset classes utilized.

Regent Newlin asked whether Wilshire will be recommending that the Regents get involved in alternatives. Mr. Friedburg said regulations and legislation of Iowa really limit the Regents’ ability to invest in a lot of the asset classes. Private equity would be one of those examples. Hedge funds would be another example. Regent Newlin asked if they were statutorily restricted in that regard. Mr. Friedburg said yes.

Mr. Friedburg said a major point that exemplifies the asset allocation is at the total fund risk return on the five year level, it looks good. The risk return graph includes total funds from Wilshire’s manager database, and includes a broad look at endowments and foundations. The Regent returns are pretty commensurate with the risks being taken. The Regent investments are almost in the top quartile in terms of returns and in the bottom quartile in terms of risks. Mr. Friedburg said the Committee has been compensated for the amount of risk they have taken and also exceeded the benchmark.
Regent Neil said for comparison purposes, he wished Wilshire had done the asset growth on a five year basis. Mr. Friedburg said they could run that.

Mr. Friedburg identified that in U.S. equity, the Regent investments look good on a relative basis, with returns in the second quartile, 29 and 38 percentiles, respectively. Also, commensurate with the risk, in the lower quartile. The Regents again had higher than average returns, with higher than average risk. One of the major risk drivers was Seneca’s returns in the early part of this period and also their negative performance at a later time. About two or three years ago, the Regent policy benchmark was changed from the S&P 500 to the Wilshire 5000, which allowed for a greater inclusion of small cap securities, which has been a positive contributor to the fund, as small caps have out-performed larger over the time period.

Mr. Friedburg explained the Regents have higher returns with less risk over the period, where one would want to be on a Risk Return graph. Some of the added risk the Regents have had over the long term portfolio, is due to the relative nature of the international equity Allocation being 7% versus a national average of 15%. In talking about the overall performance of most markets, where the strongest performance has been over the last couple of years is International Equity markets, emerging markets, high yield bonds versus relative. It has been the riskier asset classes that have been rewarded. Overall, the Regent portfolios have performed quite well.

Mr. Friedburg said the current international manager, Grantham Mayo, just started and only have one full quarter of performance, but so far it has been positive.

Mr. Friedburg further discussed fixed income returns were lower with higher risk than most of their peers. Most of this was driven by INVESCO’s performance throughout the time period. They are no longer a fund manager for the Regents. Another Regent policy restricts investing in non-investment grade bonds or junk bonds, which were very positive contributors to performance for others.

Vice President True said that one of the things shown earlier was contributions being listed. This was a helpful way of showing, not just the investment return, but also money coming in and out. Although it’s called net cash flow, it was really contributions from donors, into the endowment. One of the items to make note of, the University was fortunate this quarter to have an additional $700,000 contribution for endowment scholarships.

Regent Newlin asked how much they were obligated to pay out of the endowment portfolios. Vice President True said they pay out 5% on a rolling 12 quarter basis.

Regent Neil called to the Committee’s attention an article in the Des Moines Register yesterday, which said there were some very good investment individuals in some of the Universities. It doesn’t happen that the Regent Universities are leading that pack, but it’s an Iowa school. They invest money as a competition between three universities.

The Committee received the report on Wilshire Associates’ performance review by general consent.
INV 5. **Variable Rate Bonds**

Regent Neil explained this presentation was an outgrowth of the University of Iowa Hospitals Executive Board Committee discussion in November on fixed versus variable rate.

Barry Fick of Springsted discussed the various challenges and opportunities offered by different types of debt issuance, specifically fixed rate versus variable rate debt. The presentation was designed to give education and background information on the types of debt.

There are many financial and non-financial factors that influence the choice of which type of financing to pursue. The flexibility for pre-payment, the ability to manage the balance sheet, to manage debt financings, to accumulate rainy day funds, and to provide a context to the major question in the current interest rate environment, where rates are relatively low.

During the past 10-12 years, Springsted has seen a significant number of institutions, both at the university level, college level, higher education in general, that have gone towards issuing more variable rate debt than in the past. At the Big 10 level, there is Michigan State, Northwestern, Indiana, Ohio State, Purdue, all of which have at least 10-20% and sometimes 30-40% of their debt outstanding as variable rate forms of debt.

In a fixed rate environment, when you issue debt, the interest rate is set and does not change until the debt is paid off or is refinanced. In a variable rate environment, the debt changes more frequently, either weekly, daily, monthly or some other time frame. In deciding on what type of debt to issue it is important to look at Treasury Regulations, individual state requirements, and market preference limitations. In general, the benefits that can be offered by variable rate debt, in terms of overall lower interest rates and increased flexibility, are offset by some additional burdens, both from a regulatory and an administrative perspective.

For variable rate debt, there are more parties involved, from an administrative level to initial issuance. In variable rate financing, additional counsel are involved for negotiated sales. The Board has always used, with one or two exceptions, a competitive sale process, where public bids are taken for the bonds offered and the winning bid is the one that offers the best price and the lowest interest rate. In a variable rate offering, competition is not a function that is workable in the market. So the Board would enter into a negotiated process. To maintain the competition in the marketplace, competition is conducted to select the initial firm or firms that will be used in offering the debt, but there is the negotiated sale.

Regarding the variable rate debt, there is additional monitoring opportunities as the debt goes through time. Springsted provides clients that issue variable debt with debt performance compared to the market, in general and compared to past performance on their own individual debt. Those advantages, or additional operating and administrative tasks, are not necessarily present in fixed rate debt. In fixed rate debt, once you put the rates in place, they stay where they are. For tax exempt bonds, oftentimes there is a period within which you cannot refinance. If there is some non-financial or other financial reasons one would want to refinance, you would be precluded from doing that, at the cost of suffering some additional financial penalties for refinancing.
With variable rate debt, you have significantly overall lower costs of borrowing. The charts on the last page of the handout shows that they have looked at the variable rate and fixed rate numbers for the last 20 years, since 1984.

Regent Newlin said you would expect that where interest rates were going down. He asked if you went back another 20 years where interest rates were going up, what would be found. Mr. Fick said from a mathematical perspective, there would be a smaller gap between the two, but it would still be that variable rates would be slightly lower than fixed rates, in large part because the average comes out to be the same.

Mr. Fick said that a number of their clients will issue variable rate debt in the event that they are anticipating there will be a capital contribution coming in from a potential donor, who would want to use those funds for the construction of a project. The donation will come in over time, but the project should be done now, people will issue variable rate debt for that purpose and pay it off.

People also use variable rate debt when they may have multiple projects at varying times. They maintain the ability to integrate the different projects, so in the future, they can take the variable rate debt and convert it to fixed rate debt, if it makes sense, or retain it as outstanding variable rate debt.

One of the keys to understanding why institutions and entities will issue variable rate debt in combination with fixed rate debt is that, for example, the Board of Regents is in the debt market multiple times per year. As a consequence, unlike those of individuals who need to get a mortgage for one house or maybe two mortgages outstanding at any one time, the multiple number of bond issuances that they would do for the Board tends to lend itself to trying to get some additional financial flexibility, in terms of the ability to mix and match fixed and variable rate finances.

With the judicious use of variable rate financing, an entity can lower its overall cost of borrowing much like the United States has tried to do over the last few years, with discontinuing the issuance of 30 year trade coupons and the heavier reliance on short term 30 days, 90 days, one year, five and ten year treasury notes.

There may be a situation where the issuer would like to budget as if the bonds were fixed rate debt, and provided that one complies with federal arbitrage limitations, you can set aside the extra funds that are coming in and use those funds when the opportunity presents itself to prepay the debt much earlier than you would otherwise if you budgeted at the lower actual rate. At the same time, you have the ability to reduce your overall financing costs.

President Forsyth asked for a discussion of what you can still do in terms of arbitrage, because 15-20 years ago, there were huge opportunities for balance sheet management and arbitrage and it's more limited today. It still can be used. What are the arbitrage opportunities that exist for the Hospital.

Mr. Fick said for the Hospital or any issuer that would use variable rate debt, to the extent that the budgeted amount of what you anticipate paying for debt service exceeds the amount
of actual interest that you have to pay on that debt service, that additional amount can be retained, provided that the budgeted amount is not dedicated and placed into a specific fund that is deemed only available for repayment of the bonds. As long as those funds would be generally available to creditors of the institution, then you should be able to avoid having to make arbitrage payments and be able to retain those funds for other uses.

Regent Downer said one of the things the UIHC Executive Board Committee talked about after its meeting was the effect this could have on the ratios. While he appreciated the funds could be set aside to pay off the variable rate debt, if they get into an interest rate climate where that is advisable. It also can severely affect liquidity. When the payment has actually occurred, so that you vastly reduced liquidity, in effect what might be the consequences of that in terms of bond ratings or other effects this might have on the institution that did it.

Mr. Fick indicated the mix of various types of debt that an institution has outstanding is evaluated. Specifically with regard to variable rate debt, the ability to make repayment on that, from existing assets that are on hand as part of the normal asset management of an institution; otherwise, there is the ability to take the variable rate debt and actively manage it. Another alternative would be for them to convert the variable rate debt to a long term fixed rate repayment and then use those additional generated liquidities, to be functions of a payment method for those bonds, as you go to the future. Oftentimes in variable rate financing, if you don't set aside sufficient funds to prepay the debt, you would engage a third party provider to provide that liquidity in the event there was a need to prepay those bonds and there were no willing buyers in the marketplace. That is an additional expense that is sometimes incurred with variable rate debt, which would take the 90 basis point difference and reduce it by 20-30 basis points in general in the current market and up to 50-60 basis points in a less favorable market. The rating agency looks at the overall liquidity of the individual entity issuing the debt. In the case of a hospital, for example, where one of the key criteria from a rating agency perspective is the amount of funds on hand to cover operating expenses, the rating agencies are slightly less concerned than they would for an entity that normally would not maintain short term investment balances.

Mr. Fick said that costs of debt go up in a rising interest rate environment. Presumably, the investment earnings on short term funds will rise also. Interest rates may not rise exactly by the same amount that interest costs go up, but it is going to go in the same direction. Therefore, with variable rate debt, the issuer has a built-in hedge, so that you can mitigate any rise in interest rates.

Mr. Newlin asked if would be appropriate to ask Vice President True to give his views relative to the University of Iowa and University of Iowa Hospitals.

Doug True, Vice President of Finance and Operations, University of Iowa, said the University Hospital has legislative authority, subject to the Board’s approval, to issue an additional $75 million in debt to finance capital projects. The University’s conclusion, after talking with Mr. Fick and bond counsel, was that they would be financially better to proceed, under the Board’s authority, to issue all or any part of that $75 million as variable rate. Right now, the bond issuance plans for next year are to issue Hospital fixed rate issue in March and a $50 million variable rate issue later in the year. Their preference at this point is to have a single issue of $75 million in some form of variable rate debt.
Mr. Fick said from their perspective, they are confident that the amount of the variable rate debt that the Hospital is asking to issue as variable rate debt would not be an issue. They do not anticipate any problems with marketing that debt successfully and getting favorable interest rates in the market.

Regent Newlin said if there was older debt, how much was left. Vice President True said it was to be paid off this year or next year at the latest.

Regent Neil asked about the $25 million already issued, if it was fixed or variable. Vice President True said it was fixed. Regent Neil said, given today’s environment, why would they issue variable debt. He felt fixed rates are more advantageous for the longer term.

Mr. Fick said it was a logical conclusion to make. He said the key for variable rate debt is that looking at the future capital needs of any organization. The amount of capital projects UIHC has projected is very substantial. Some of those projects will be done through internally generated funds, some through debt financing. Variable rate debt becomes a tool that they can utilize and properly manage more frequently than fixed rate. With fixed rate, it is looked at every couple of years. Now with the 10 year anniversary for a number of the academic revenue bonds coming up, they’re actively monitoring the refunding opportunities. They do the same thing on the variable rate side every three months.

Mr. Fick said monitoring variable rate bonds is a lot more work. Regent Neil asked what the “lot more work” would cost the Board. Mr. Fick said from their perspective, there is no additional charge for that monitoring.

Regent Forsyth asked what scenario might play out that the Board would say, we would have been better served to have issued fixed rate debt as opposed to variable, or is there any scenario that can be modeled that’s likely where it’s always better with variable. Mr. Fick said almost every scenario they model is always better with variable, or some mixture.

Regent Forsyth asked Ed Bittle, bond counsel, for his comments. Mr. Bittle said it appeared to be pretty well covered. He said they had prepared all the bond resolutions to date on the basis that there would be not be variable rate financing. There were discussions about closing the outstanding $25 million and not issuing any more bonds on a parity with them. Variable bonds would be issued under a new bond resolution. They would have to work around the restrictions of the outstanding bond resolution. In going forward, if the Board changes policies and considers variable rate bonds, changes would be needed in documentation. It is certainly doable.

President Forsyth asked whether a mixture of 25/75, with the 75 being variable rate debt was reasonable. Mr. Fick said the $25 million fixed rate debt and $75 million variable rate debt is perfectly acceptable and easily marketable in the current market situation.

Report accepted by general consent.
INV 6. Modification of University Banking Relationship

Vice President True said the University went out to bid for a retail lock box service and the best bid was Bank of America. They would like the Board to authorize the University to use Bank of America for this retail lock box service, which is basically a check collection point, to maximize cash flow and availability and allow the University to use a Bank of America branch in Orlando during the next few weeks during the Bowl game.

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<td>Regent Downer made a motion to authorize the University to accept the bid Bank of America for lock box services and to use the Bank’s Florida branch during the Bowl game. Regent Newlin seconded the motion.</td>
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MOTION CARRIED UNANIMOUSLY

INV 7. Investment Policy Manual Modifications (Soft Dollars)

Vice President True said that individuals in the Treasurer’s office and the Board’s investment advisors worked together to propose a policy that is compatible with the University’s risk aversion. This includes a good execution of trades with brokerages and the flexibility for fund managers to use soft dollars to impart research services. It would allow those fund managers to trade in large lots.

Mr. Madden said Vice President True described the recommendation very well and Iowa State University supports it. Some national issues could change in terms of soft dollars and how commission structures are handled. With full disclosure, the proposed policy seems to be in their best interests.

Regent Neil asked Wilshire if they were comfortable with the action. Wilshire representatives responded affirmatively.

Regent Neil said this would be counted as a first reading of the changes to the Board’s investment policy.

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<td>Regent Newlin made a motion to approve the changes, as a first reading, to the Board’s investment policy. Regent Rokes seconded the motion.</td>
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MOTION CARRIED UNANIMOUSLY
Regent Neil adjourned the meeting at 2:15 p.m.

Pamela M. Elliott  
Director, Business and Finance

Gregory S. Nichols  
Executive Director

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