BOARD OF REGENTS, STATE OF IOWA
Iowa State University
Ames, Iowa

Investment Committee
Memorial Union
Sun Room

March 14, 2005 – 10:15 a.m. – 12:30 p.m.

Persons in attendance (not all-inclusive):

Committee members: Owen Newlin, Acting Chair, Mary Ellen Becker, Jenny Rokes, Rose Vasquez, President Pro Tem Robert Downer (ex officio)

Call to Order, Introductory Comments

Regent Newlin called the meeting to order at 10:15 a.m.

Regent Newlin introduced new Regents to the Committee, Michael Gartner, Tom Bedell and Ruth Harkin.

INV 1. Minutes from December 15, 2004, Committee Meeting

MOTION	Regent Becker moved to accept the minutes, of the December 15-16, 2004 meeting. Regent Rokes seconded the motion. **MOTION CARRIED UNANIMOUSLY**

INV 2. Investment and Cash Management Report for the Quarter Ended December 31, 2004

Mark Friedberg from Wilshire Associates, gave a brief background to the new Regents that included a market review for each of the specific markets for the current quarter as well as for the three year, five year and ten year returns.

The total Domestic Equity Composite as a whole, out-performed the market, not because the Managers out-performed, but because of the where the Board was weighted in the structure.

Mr. Friedberg said there was a slight over-weighting to U.S. Equity at the end of the quarter, a slight under-weighting to Fixed Income and slight over-weighting to International, all within the policy ranges. That slight over-weighting helped the Board's performance over the quarter.

Overall for the quarter, the Board's portfolio exceeded its benchmark by 20 basis points; 8% versus 7.8%. The one year period, there was under-performance relative to the benchmark and an absolute return of 9.5% versus the Indexed 10.6%. Over the three year period, the Board remains about 40 basis points ahead, 6.9% versus 6.5%. Over the five year period, 4.4% versus 1.8% and matching on the inception returns.

Total gains for the University of Iowa portfolio was approximately $15 million. For Iowa State, the total gains were $9.8 million for the quarter.

Mr. Friedberg said Domestic Equity out-performed the benchmark by about 20 basis points for the quarter, under-performing by 2.2% for the one year period. The majority of this under-performance was due to Seneca, the manager the Board is in the process of replacing. On a three year basis, the fund under-performed by 2.7% versus the benchmark; the same manager primarily attributable to the under-performance.

In looking at it over a longer term, performance is still positive, versus the benchmark's –1.5%.

On the Fixed Income side, there was another switch in managers, where some of the previous managers were terminated and the Board brought in two newer ones. Both of these managers out-performed for the quarter, slightly out-performing by .1% or 10 basis points and matching performance for the one year period.

Over the three year period, the Board's portfolio performance: 5.5% versus 6.2%. On the five year, 7.2% versus 7.7%.

On the International side, this is probably the strongest area of out-performance. The one year period looks good: 22.8% versus 20.2% and 17.7% versus 11.9%. It out-performed on the three and five year basis by 5.8% and 8.1% respectively.

Wilshire's philosophy is to not make "bets" relative to the market. They are not going to try and predict when Large Cap is going to out-perform Small Cap or Value is going to out-perform Growth. Wilshire will try and structure the portfolio, eliminate the amount of biases that are in the portfolio, and focus on areas where they do want to add value, which is on Manager Selection.

Mr. Friedberg said overall they had no concerns with the existing Managers. The one Manager they do have concerns with is being replaced and will not be part of this program when they look at it for the next quarterly review.

Mr. Friedberg wanted to discuss one Manager briefly on the Operating Portfolio, which is BlackRock. At the end of January, they announced an acquisition. They acquired State Street SSRM Holdings, Inc., including State Street Research and Management Co., and SSR Realty Advisors.

Regent Gartner asked if Iowa State and the University of Iowa were invested separately. Mr. Friedberg said yes, which was partly by the guidelines that the State hands down. He said the Board wasn't able to perform a master trust where they could be invested together.

Regent Newlin said they do take advantage of the amount of money that's involved from fees. Mr. Friedberg said that from a fee perspective everything gets aggregated. The Board gets the benefit of having all the assets together. You lose some benefits, for costs from an operational standpoint, if everything were to be a master trust. You see some of the performance differences between Iowa State, the University of Iowa and some of the others. That is mostly due to timing differences.

Regent Newlin asked if that was by law. Warren Madden, Vice President of Business and Finance for Iowa State said that the policies are set by statutory regulations. The bulk of the funds are endowments specifically given to each institution. When these were set up, there was some concern about whether transferring management away from one of the institutions was going to be a potential issue. They were getting the benefit of the pooling on fees. Most of the differences are timing, associated with putting money in and taking money out.

Vice President True said they're identical investment programs. When they were conceived 15 years ago, the idea was to have the lowest possible expenses and get the value of investing together, which has been demonstrated by some of the results. The slight differences from time to time, are trivial in the endowment.

Mr. Madden said for the benefit of the new Regents, that these are University managed endowments, not the foundations that are associated with the Universities. Much of this is money that was committed a number of years ago, before foundation structures were as active as they are. Most of the new contributions are going through the foundations, rather than the institutions.

Regent Newlin said these particular monies are only going to grow by appreciation. Mr. Madden agreed but there are some exceptions. He felt in general that donors are first encouraged to consider the foundation option before the institutions. They do have donors who have an interest in working with the University. The investment policies are not completely identical between the foundations and the University. If you actually look at performance over time, they are substantially similar in the nature of funds; different managers, but overall, long term performance is not significantly different.

Mr. Friedberg summarized the three managers that were presenting to the Committee: BlackRock, Manager of the Operating Portfolio; LSV Asset Management, endowment manager of Small and Mid Cap Value stock; and Reams Asset Management, a Fixed Income Manager for the portfolio.

An item to notice is the number of products managed by the manager. There is a wide range, 20 for one, 200 for another.
Regent Harkin asked what the process was in Manager selection. Mr. Friedberg said it's a longer process. Briefly, the Board looks for a new manager. Wilshire has a dedicated manager research group, as well as individual consultants that are looking at these managers very often. Wilshire monitors performance, looking at them on a quantitative, as well as a qualitative basis, and rank each manager. The process is relatively transparent. Part of that review involves Wilshire receiving qualitative questionnaires, as well as a database of about 4,000 managers for comparing managers, using 200+ different types of analytics. The Board meets with each of the managers on an annual basis. Where there is a problem with a manager, Wilshire meets with them. When selecting new managers, there is a search process which screens both on qualitative and quantitative factors. Wilshire identifies the top 10 and recommends 3-4 that usually come in and present to this Committee or a subset of this Committee. One of those selectees is recommended to this Committee.

INV 3. <u>Performance Review of Fund Managers</u>

<u>BlackRock – Operating Portfolio</u>

Marcy Rappaport, Vice President of BlackRock, spoke briefly about the organization. Last August, BlackRock announced the intent to acquire State Street Research and Management, which consists of two parts: the asset management group that was located in Boston and the realty group that was located in New Jersey. The transition was finalized the end of January.

There were four parts to the BlackRock's decision to acquire State Street Research.

- Mutual Fund business
- Equity business
- A premier State Street realty shop with about $7 billion in all institutional assets

- Alternatives Platform such as asset backed securities, energy products and energy hedge funds.

Mark Friedberg asked if there had been any departures. Ms. Rappaport said there were none on the BlackRock side but some on the State Street side.

Mr. Friedberg asked about the team that joined in Boston; if Mark Marinelli, CIO of SSR and Jolene BlackRock run the Cash Management. Mr. Friedberg asked if that affected the product they are managing for the Committee. Ms. Rappaport replied no. BlackRock has a liquidity business, $70 billion in Money Market Funds, more of pure cash type instruments, that's run out of Delaware. Mark Marinelli has gone to Wilmington to head up that effort.

Regent Newlin asked relatively, how big BlackRock was as opposed to how big the company was it purchased. Ms. Rappaport stated BlackRock's assets at the end of December totaled $342 billion. The total acquisition size was approximately $50 billion, from State Street. There was $7 billion from the real estate, $20 billion on Fixed Income, $20 billion across the Equity products and $1-2 billion in both Liquidity and the alternatives.

Mr. Friedberg asked about the $20 billion that was added on the Fixed Income side, how it was being assimilated and if there were any capacity issues. Ms. Rappaport said the majority of their Fixed Income products were "core" Fixed Income. Those were Lehman Aggregate type, very non-esoteric.

Ms. Rappaport commented that BlackRock opened a couple of new offices; however, the organizational structure of BlackRock has remained unchanged since the founding of the firm.

Ms. Rappaport pointed out BlackRock short term duration assets, the product the Board is invested in, is just over $15 billion. These flagship products have seen a substantial amount of growth across the specialty mandates. BlackRock introduced several new institutional funds in the last year, both short duration, called enhanced income, as well as a Treasury Inflation Protected Securities (TIPS) fund on the Institutional side.

Ms. Rappaport pointed out BlackRock's philosophical approach to active fixed income management has two parts:

- Views on the direction of interest rates
- Added value through sector rotation and sub-sector rotation and security selection

BlackRock will evaluate the different components of the Fixed Income market; Treasuries, Agencies, Corporates, etc. and identify on a risk-adjusted basis where they think there is value going forward. They will over-weight those sectors and under-weight the areas they feel are over-valued. BlackRock is actively trading the portfolio and making small changes to those weights throughout any time period.

Ms. Rappaport said BlackRock feels the economy is growing at a healthy pace. They have positioned the portfolio since the middle of last year to be under-weight duration, positioned for interest rates to increase. They are expecting and looking for the Feds fund rate by the end of the year to be more in the 3½% to 3 ¾% range and feel they are in the higher end of the general market in terms of expectations and growth. BlackRock feels inflation is under control.

<u>Reams Asset Management Company – Fixed Income Portfolio</u>

Mr. Friedberg said Reams is one of the Fixed Income Managers in both the Iowa State and University of Iowa portfolios. Reams has been managing assets for the Committee since the end of 2001.

Tom Fink, Managing Director, made the presentation on behalf of Reams Asset Management Company. He highlighted the company, which is an employee-owned investment management firm established in 1981. Reams focuses on U.S. fixed income for institutional clients and does no retail asset management. They do have a number of long-term client relationships, as a result of long term performance.

He said that as of December 31, 2004, Reams had 39 institutional Fixed Income accounts with about $10 billion under management and 11 investment professionals.

Reams' Fixed Income products have always been a core and core plus asset management, which represent $8 billion out of the $10 billion they manage. About seven years go, Reams introduced High Yield and Intermediate portfolios. More recently, they have introduced a number of new products; a low duration and long duration product, and a real return of Treasury Inflation Protected Securities (TIPS) mandate.

The bulk of Reams business is separate accounts, but they also have institutional Mutual Funds. The firm has recently introduced a family of institutional Mutual Funds, called the Columbus Funds.

Mr. Fink reviewed the professionals in the firm and the individuals that work with the firm. He said Reams manages with a team approach. As far as deletions to the team, one associate left last year to go back to school. One additional professional has been hired to head up the Operations group.

Reams' philosophy and decision process; is predicated on a view on volatility, which Reams sees as a key driver of performance in the Fixed Income market. That core belief leads Reams to focus on several things: long term value and total return. They look at what is likely to out-perform over the next two or three years, rather than just two to three months.

Reams employ both macro and bottom-up strategies to try and add value, and will structure a portfolio from an overall duration and yield curve perspective, with more macro decision making and trying to add value on securities selection.

Mr. Fink felt the key to their process was being able to react opportunistically to valuation discrepancies in the market. When volatility picks up and valuations change, they like to have a well structured portfolio that they can take advantage of opportunities.

Reams' philosophy involves a two step process. The first is the macro decision making in the portfolio, the overall duration, the overall yield curve decision. Their goal is to determine whether the overall bond market is rich or cheap and then position the portfolio accordingly.

The next step of the process is the overall sector and security selection decision. He said the goal was to purchase bonds offering the highest risk adjusted returns in the marketplace.

Mr. Friedberg asked how much does Reams' estimate of inflation determine the value added in the portfolio. Mr. Fink said over longer periods of time, about 60% of the added value in the portfolios come from the securities/sector decision and about 40% comes from the more macro decisions.

Regent Newlin asked if the 10 year rate is 4½%, if he could calculate the inflation-adjusted rate that's equivalent to the 4½%. Mr. Friedberg said it would be 2½%.

Mr. Fink discussed the objectives and guidelines on the Board's accounts which have changed slightly since the last meeting about two years ago. Reams is looking to out-perform the Lehman Aggregate Bond Index.

Reams' performance for the portfolios was 4.75% and 4.8% versus the benchmark of 4.34%, about 50 basis points over the benchmark.

Over the last couple of years, many market participants have been expecting rates to continue rising. That has not happened much and 4.5-5.0% in the high quality bond portfolio over the last couple of years, given a low inflationary environment, a low rate of return environment has been pretty good on an absolute basis.

For the University of Iowa endowment portfolio, longer term, since August, 1, 2001, return performance was 5.64%, which slightly trailed the benchmark of 6.14%. More recent performance has been pretty good.

Mr. Fink said the key drivers of performance last year have been how Reams performed versus the benchmark.

He said some of the risk sectors in the portfolios have been under-weight, when looking at mortgage-backed securities or corporate bonds, Reams felt they had been over-valued in the marketplace and they can under-weight those securities. Those securities actually performed very well in the second half of 2004.

Vice President Madden, Iowa State University, asked if the performance figures were net of fees. Mr. Fink said they were gross of fees. Mr. Friedberg said on the Wilshire report, the figures are net of fees.

Mr. Friedberg asked if Reams had an estimate where they expect the Feds target to be at the end of the year. Mr. Fink said 3.5-4.0% they felt was good. If there is any surprise, they would lean toward the surprise of lower Fed funds versus higher for that range.

Reams expect 3%+ GDP growth. Inflation has risen for the long term and the forecast remains at 2.0%. The Fed has been tightening since the middle of last year. Reams expects that to continue.

Reams has been running a shorter duration portfolio and are back to neutral now, as far as overall interest rate risk. They are moving to a bulleted portfolio, as far as having more securities in the intermediate sector of the yield curve. Credit and mortgages remain under-weight in the portfolio.

Mr. Fink commented that the three different portfolio return information was essentially identical. The Quasi-Endowment portfolio market value was just short of $47 million as of December 31, 2004. The average portfolio duration over the overall interest rate risk of the portfolio was 3.7 years, which was less than the overall index at 4.3%. Since year end, the portfolios have moved to a neutral position. Both the portfolio and index are roughly 4½ years in duration currently.

<u>LSV Asset Management Company – Client Portfolio Services</u>

Mr. Friedberg introduced Keith Bruch, Director of LSV as a Small Cap Value Manager, somewhat quantitative in nature and somewhat unique in that the quantitative aspects are based on an underpinning of behavioral finance.

Mr. Bruch, Director of Client Portfolio Services, is based in Chicago with the investment team. He highlighted that LSV is a quantitative firm with an academic background. The three founding partners (Joseph Lakonishok, Andrei Shleifer and Robert Fishny) are all university professors that collaborated on a lot of work in the area of contrarian investing and behavior finance and developed a quantitative model that they have used successfully since the start of the firm in 1994, across a variety of different strategies, including the Small to Mid Cap strategy, which they manage for two of the Board's portfolios.

He said the ownership and structure of the firm has not changed. Eleven of the senior partners of the firm own 57%. Joseph and Robert are the two significant shareholders. Ownership is reviewed on an annual basis and at the end of 2004, there were no changes made. The remainder of the firm is owned by their Venture Capital partner, SEI Investments.

Currently, LSV stands at $37 billion in assets under manager. There has been growth in the business, particularly on the non-U.S. side. LSV applies the same quantitative model across the different strategies in the U.S. and outside the U.S. The Board's portfolios have grown to about $20 million aggregate, since LSV started. They manage about $2 billion in the Small to Mid Cap area of the market.

Mr. Bruch said they have lost one client. Late last year, one corporate client went through a restructuring and outsourced all of their pension assets. LSV was not let go as a result of performance, but a decision on the client's part to change strategies.

He pointed out different strategies LSV manages. They are closed on all U.S. active strategies, from Large Cap down to a Micro Cap. Not long after the Board hired LSV, they closed the Small to Mid Cap portfolios to new assets, to maintain the integrity of the process. Since there are liquidity issues in this part of the market, LSV wanted to make sure they continue to buy and sell the securities without putting much pressure on the market.

Mr. Bruch said there is an ongoing process of research at LSV that the founding partners and others are always looking forward to enhance the model, to tweak what they do to continue staying on the cutting edge.

LSV added a few people in the last several years to its Client Service area, and three academic advisors. LSV has worked with a number of individuals in the academic community to help LSV with research and consulting, to help LSV continue enhancing what they do from an investment standpoint.

Mr. Bruch reviewed the relationship with the Board, which started mid-year in 2002, with both portfolios. There has been some cash flow and rebalancing on each portfolio.

He talked about the summary of the Equity markets. He pointed out the smaller names over the last five years have done very well. Value has also done well after the difficult period in 1998-1999, as well as Small Cap names. In looking at the five year values, with Value versus Growth, the Small to Mid Cap Value was up roughly 16%, whereas the Growth area of the market is down on the average 7%.

LSV's portfolio is a conservative portfolio and tends to protect very well in down markets and tries to keep up in up markets and strong markets like 2003. LSV struggles at times with rapidly rising markets. Even in the value area of the market, some of the lower quality names worked well in that time period. LSV likes to buy companies that have earnings that are paying a dividend that have strong cash flow. In 2004, the portfolio was slightly above the benchmark, 22% for the University of Iowa portfolio and 23.1% for the Iowa State University portfolio versus 21.6% for the benchmark. Some of the exposure to the defensive sectors of the market did very well, in the industrial and energy areas. That was offset, to a certain extent, by some poor selection in technology. Even as a Value Manager, they do have some exposure to technology names. Overall, they were a little bit above the market in 2004.

Mr. Friedberg asked what the major driver was in the model's under-performance. Mr. Bruch said in 2004 it was stock selection. In looking at attribution, you can add value from over or under-weighting sectors of the market, you can add value by picking individual stocks. LSV takes modest "bets" from a sector standpoint. They will be no more than 5% over or under-weight in any one sector in the market. LSV maintains a diversified portfolio. He felt LSV fell short last year in the higher growth areas of the market: technology, they had about an average weight to the benchmark, but the picks were not as good.

Mr. Friedberg asked which components of the model worked and which didn't work. Mr. Bruch said they look at a number of different valuation and momentum factors and come up with an expected return for each stock. It is broken out into valuation, price to book, price to earnings, price to cash flow, type of measures. Price to earnings worked well last year when looking at the efficacy of individual factors. Size didn't have much of an impact on the portfolio and maybe a modest over-weight to dividend yielding stocks. There was no real clear part of the model that worked or didn't work last year.

Mr. Bruch discussed the characteristics of the portfolios as of January 31, 2005. The portfolio constructed traded at 14 times earnings versus 21.6% for the value benchmark and 26.1% for the Russell 2500, a broader core benchmark. LSV is looking at stocks for the Board's portfolio from $100 million in market capitalization to $5 billion.

LSV does not take large sector bets, but believe in diversification. LSV has some exposure to all the areas of the market, regardless of how cheap or expensive.

Consumer Staples would be the one area where there is a maximum over-weighting. That was primarily in food and beverage names that have gotten relatively cheap. The Consumer Discretionary area is not a very homogeneous sector, but they have some exposure to some auto components, home builders and household durable names. Some of those have done well. There are a number of small bets in the technology area and are about even with the benchmark. They are finding some names to get invested in, possibly 15 names they have in that sector of the market.

Mr. Bruch discussed the major components of the model and briefly discussed some of the changes that were made to the model.

Mr. Bruch discussed the portfolio holdings. They put together the portfolio by the numbers. They turn the portfolio about 30% every year. Every four to six weeks they re-run the model in the absence of any cash flow, take an opportunity to improve the portfolio and generate buys and sells. In recent times, they have added a few names, still in the more defensive areas of the market: industrials and material sectors.

Regent Newlin accepted the three reports by general consent.

INV 4. <u>Policy Manual Change – Initial Common Stock Offerings</u>

Mark Friedberg from Wilshire Associates recommended that the Board approve the modification of the investment policy regarding how much initial common stock offerings (IPO) sold to the public is permitted within the portfolio.

As the Board was hiring two active equity managers, Wilshire worked on the guidelines with each manager to make sure they are consistent with how they manage the portfolios and they're not taking any undue risks. Both managers had some concerns with the IPO language in the guidelines.

Previously, the managers were limited to a maximum of a 5% weighting in any security that's been in an initial offering over the previous 12 month period. The managers requested a little more leeway regarding this guideline. This recommendation provides the potential where securities, like a Google, could have a much larger percentage of the Index. With the current Board limitation in place, the managers would not be able to either weight to the Index nor make an active bet around that weighting in the Index.

Wilshire recommends increasing that limit from 5% to 8%. In limiting the managers' abilities, it increases the amount of excess risk the managers could take relative to the benchmark. Wilshire would prefer to minimize the excess risk relative to the benchmark.

Regent Harkin asked if it was actually increasing the amount of excess risk. Mr. Friedberg said it would increase the amount of leeway the manager has. He said the Wilshire 5000 is under 4% amount in these types of securities. If the amount of the securities were to increase to say 7%, but the managers were limited to be below 5%, the Board would be causing the managers to have an under-weight to the securities of 2%, which is actually increasing the amount of excess risk they would take relative to the benchmark. That would also be a risk the fund manager might not normally take.

Regent Harkin asked when it would be implemented. Mr. Friedberg said they would implement it now, with the hiring of the managers as part of the guidelines.

MOTION	Regent Vasquez moved to recommend that the Board approve the immediate modification of the Board's investment policy regarding initial common stock offerings sold to the public. Regent Rokes seconded the motion. **MOTION CARRIED UNANIMOUSLY**

INV 5. <u>Updated Committee Work Plan</u>

Pam Elliott, Director of Business and Finance, Board Staff presented the updated Committee Work Plan. In May, 2004, a plan was put together for the Committee discussions over the next year. She pointed out for September 14-15, 2005, it was hoped they would not have to select a new Fund Equity Manager.

She said previously all portfolio managers presented performance reviews to the Committee at one time. The work plan spreads these presentations out at each of the four quarterly investment meetings.

Regent Harkin asked how this differs from the prior schedule of addressing investments for the Board. Ms. Elliott said the annual performance review of Wilshire was added as well as an annual update on the Board's investment policies.

Regent Bedell asked why the Board didn't transfer the management of the funds over to the Foundation to consolidate management of the funds. Ms. Elliott said the Foundations are separate, non-profit entities that are not under the control or governance of the Board of Regents. If the Board turns over its investments to the Foundations, the Board would not be able to exercise control.

Warren Madden, Vice President of Business and Finance for Iowa State University said that legally these were endowments that are given specifically to the University. If they were going to be moved to another entity, the legal ability to do that would have to be addressed. There are probably certain donors who feel strongly about who was managing the funds, and that might present issues in some circumstances. The Board would also be giving up their fiduciary responsibility of overseeing the portfolios. He did not feel that from an institutional level, they would be supportive of that kind of a decision.

Regent Newlin commented that donors of each individual university are encouraged to give their funds through the Foundation and not directly to the university. As time goes on, in theory, these funds will be smaller in relative terms to the Foundation funds.

Mr. Madden said some are statutory. In Iowa State University's case, for example, some of the biotechnology funds are legislative appropriations. They are obligated to manage those under the terms established.

Regent Newlin accepted the Work Plan by general consent.

Regent Downer asked that the minutes reflect appreciation to Interim Chair Newlin for assuming the responsibility for conducting the meeting. With the resignations, they were short on chairs. Regent Newlin was already chair of the Audit Committee and agreed to take this additional responsibility on an interim basis.

Regent Newlin adjourned the meeting at 12:30 p.m.

Pamela Elliott Cain
Pamela Elliott Cain
Chief Business Officer

Gregory S Nichols
Gregory S. Nichols
Executive Director

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