

BOARD OF REGENTS
BANKING COMMITTEE

June 19, 2003

The Banking Committee of the Board of Regents met on Thursday, June 19, 2003, at the Iowa School for the Deaf, Council Bluffs.

Those present were:

Banking Committee members: Regents Amir Arbisser (chair), Robert Downer, John Forsyth, David Neil and Owen Newlin.

Others in attendance were:

Board of Regents member Sue Nieland;

Institutional representatives: Douglas True, Stacey Cyphert, Gregory Geoffroy, Warren Madden, Mark Chidister, Robert Koob, Tom Schellhardt, Jeanne Prickett, Jim Heuer, and Dennis Thurman;

Marc Friedberg, Wilshire Associates;

Barry Fick, Springsted, Inc.;

Ed Bittle, Ahlers law firm;

David Vaudt and Andy Nielsen, State Auditor's Office; and

Board Office: Pamela Elliott, Joan Racki, Deb Hendrickson; Barb Boose, and Barb Briggie.

Regent Arbisser called the meeting to order at 8:08 a.m.

APPROVE MINUTES OF THE MAY 2003 BANKING COMMITTEE MEETING.

Regent Arbisser asked for additions or corrections to the minutes.

Regent Downer asked that page 6 of the May 22, 2003, minutes be corrected to reflect that Vice President Madden rather than Vice President True had answered his question about the rate of inflation of construction costs (third paragraph of page 6).

Regent Arbisser noted there were several follow-up items from the last Banking Committee meeting that were included on the agenda for this meeting.

MOTION: Regent Neil moved to approve the minutes of the May 22, 2003, Banking Committee meeting, as corrected. Regent Downer seconded the motion. MOTION CARRIED UNANIMOUSLY.

PRESENTATION BY STATE AUDITOR DAVID A. VAUDT.

Director Elliott introduced David Vaudt and Andy Nielsen from the State Auditor's office. She stated that Mr. Vaudt was newly-elected and began serving in January 2003.

State Auditor Vaudt expressed appreciation for the opportunity to meet with the Banking Committee. He stated that he came to state government from private industry, most recently with KPMG. A great deal of his career was focused on government auditing. He noted that the State Auditor's Office is one of the largest CPA firms in the state. The primary responsibility of the State Auditor's Office is to audit every department of state government and also to serve local governments. To the extent that CPA firms provide auditing to local government, the State Auditor's Office is responsible for oversight.

State Auditor Vaudt discussed recent changes in the auditing environment, due to corporate scandals, which will impact how auditors and audit committees carry out their responsibilities. The Sarbanes-Oxley Act of 2002 focuses on four primary areas: 1) responsibilities of management and audit committees, 2) enhancement of financial disclosure, 3) independence of auditors and audit committees, and 4) role of public company oversight boards. He said state government will experience a cascading effect of the legislation, particularly with regard to governance. He offered to work with the Banking Committee on how it might incorporate some of the Sarbanes-Oxley changes into its operations.

State Auditor Vaudt presented highlights of the FY 2003 audits, noting that separate audits were conducted of each university. Audit areas included:

- Planning and internal control;
- Assets, liabilities and net assets;
- Revenues and expenses;
- Reporting;
- Single audit;
- Supervision and review;
- Compliance;
- Information technology; and
- Performance

In the past, the State Auditor's Office has conducted financial audits of each of the special schools; however, those are not required under state law. State Auditor Vaudt provided the following alternatives with regard to the special schools: continue full-scope separate audits at each institution or perform more limited procedures. He said it would be two to three months before a decision needed to be made, and noted that internal audit is an important factor for the special schools.

State Auditor Vaudt stated that some common concepts are used in auditing the universities. Those include information technology and coordination with internal audit staffs. He stressed the importance of having good relationships and coordinating efforts with the internal audit staffs in order to rely on each other's work. Over the past few weeks, he has met with the vice presidents of finance and with the internal audit staff on each campus to begin developing preliminary audit plans.

Regent Arbisser thanked State Auditor Vaudt and Mr. Nielsen for joining the Banking Committee members at this meeting. He stated that the Board of Regents represents a large client of the State Auditor's Office, and asked how the Regents fit into the State Auditor's annual budget.

Mr. Nielsen responded that the Regents account for 12-15 percent of the State Auditor's annual budget.

Regent Arbisser said it was his experience in the private sector that accounting firms continually provide ideas on tasks that can be done internally, which results in less expensive costs for services. He asked if the State Auditor's Office was able to bring a similar service to the Regents' audits.

State Auditor Vaudt responded that the State Auditor's Office works with the internal audit staff and with management to focus on high-risk areas. He said concentrated efforts will be made with this year's audit to determine how to work more effectively with the internal auditors. The State Auditor's Office will continually try to decrease its hours to control costs.

Regent Arbisser asked if the billings of the State Auditor's Office will be itemized rather than aggregated as a charge for time. State Auditor Vaudt expressed a willingness to discuss with management teams how the auditors' time is allocated.

Regent Downer asked why the State Auditor was auditing Iowa State University's bonds but was not auditing bonds of the other two universities. State Auditor Vaudt responded that each institution has the ability to select who will perform bond audits. The State Auditor's Office was selected through a bid process to perform Iowa State University's bond audits.

Vice President True stated that the University of Iowa conducts a bidding process for its bond audits. He said Deloitte was selected to audit 8 to 10 of the University's bonded systems and KPMG was selected to audit the University of Iowa Hospitals and Clinics.

Superintendent Thurman asked if the Board of Regents has the authority to select a private auditing firm for the special schools' audits. State Auditor Vaudt responded that, at this time, the Board of Regents does not have the authority to select a private auditing firm for the special schools' audits. He stated that, from his perspective, he looked forward to working with the special schools on client service issues. He noted that he has volunteered to attend the July Board of Regents meeting to present financial statements. He will also be spending time on the campuses in the audit process.

Regent Forsyth asked for the State Auditor's process of risk assessment. State Auditor Vaudt said his office begins by building upon the risk assessment work of the internal auditors. Conclusions are reached as to the areas that are considered to be high risk. The State Auditor's Office determines which areas addressed by the internal auditors during the year can be supplemented. Duplication of the internal auditors' efforts is avoided.

Regent Arbisser again thanked State Auditor Vaudt and Mr. Nielsen for joining the Banking Committee members at this meeting.

ACTION: Regent Arbisser stated the Banking Committee received the oral presentation by State Auditor David A. Vaudt, by general consent.

INVESTMENT AND CASH MANAGEMENT REPORT FOR FY 2003 THIRD QUARTER.

Director Elliott provided introductory remarks and then asked Marc Friedberg to present Wilshire's report.

Mr. Friedberg provided a brief review of the performance report and an update of the performance through June 18. He first discussed a snapshot of major asset class returns over the last 10 years, pointing out the dispersion between the S&P 500 and the Lehman Aggregate bond index. It has been three years since the technology stock bubble burst. Since then, the market has experienced the worst downturn since the Great Depression. There has been a 26 percent per year dispersion between the rates of returns for stocks and bonds for the past three years, which was somewhat anomalous. Over the past ten years, the Regent portfolios have experienced an 8-1/2 percent return, which is in line for that time period. The Regents' expected returns are

in line with the investment management community's consensus for expected returns. He said decision making based on past performance is incorrect. He discussed a graph of risk versus return for the most recent 10 years and for the prior 10 years.

Mr. Friedberg next discussed the domestic equity market, stating that one cannot time the market. A market weighting to large and small caps, over time, will reduce the overall risk to the portfolio. He said the same was true of growth and value stocks; one cannot time the market but, over longer periods of time, the returns are expected to be similar. Mr. Friedberg referred to graphs which illustrated returns of small cap versus large cap and value versus growth stocks. He discussed which outperformed the other during particular periods of time in the last six years.

Regent Forsyth asked what the graphs would show if one looked at the same measures over the last 30 years. Mr. Friedberg responded that he would expect the returns to be very even.

Regent Forsyth referred to the equity portion of the portfolio and asked for Mr. Friedberg's recommendation for asset allocation. Mr. Friedberg stated that Wilshire's recommended structure is market-weighted large cap to small cap stocks, and equal-weighted value to growth stocks. Typically, Wilshire recommends passive or structured in large cap and active in small cap. With regard to the asset allocation between domestic and international stocks, Wilshire typically recommends a more diversified portfolio, with international capped at 15-20 percent of the portfolio.

Regent Forsyth asked if Mr. Friedberg was saying Wilshire would recommend allocating 15-20 percent of the equities portfolio to international equities. Mr. Friedberg responded that he meant 15-20 percent of the total portfolio to international equities.

Regent Forsyth asked what percentage of the equities portfolio would be allocated to large cap stocks. Mr. Friedberg responded that Wilshire would recommend 80 percent to large cap and 20 percent to small cap stocks. He said the current allocation is structured in that fashion. The Regent portfolios have a slight value bias which has helped the portfolio in recent years.

Regent Forsyth stated that it would be helpful to devote one Banking Committee meeting to discussion of asset allocation philosophy. Regent Arbisser said that was a good suggestion. Mr. Friedberg offered to attend a Banking Committee meeting to provide an educational presentation on asset allocation philosophy, etc.

Mr. Friedberg addressed the fixed income market, and presented information on returns for the last ten years. He noted that one of the Board's portfolio managers experienced

two negative bets in the portfolio. For that reason, it was expected that the manager will substantially underperform (by approximately 1-1/2 percent) its benchmark. He said Invesco will probably outperform its benchmark.

With regard to the international equities markets, Mr. Friedberg stated the Board's manager, Alliance Bernstein, had performed very well, and that its value bias had helped. Performance for the quarter, through June 18, 2003, was up substantially in every segment of the market. The total portfolio was up 12 percent year-to-date. He stated that the Chief Investment Officer of the Alliance Bernstein product, who was integral to the product, is retiring. Two people who will follow him are very capable and impressive individuals. One of the individuals has been with the product, working right next to the Chief Investment Officer, for 19 years. Wilshire representatives will be meeting with Alliance Bernstein representatives during the following week and will perform an in-depth review.

With regard to total fund results, he stated that most of the managers have underperformed their benchmarks.

Regent Forsyth asked if Wilshire was concerned about any other fund managers. Mr. Friedberg responded that, from an organizational perspective, there were no other managers for which there was concern. However, the performance of Reams, the fixed income manager, has not met expectations and is being monitored closely. He said Reams is, basically, a boutique shop with two products—small value and fixed income. Reams has been “caught” on almost every bet it made. Wilshire Associates does not want Reams to double its bets to get into positive territory.

Regent Forsyth asked if the risk was that Reams would continue to take greater risk in order to catch up. Mr. Friedberg responded that Wilshire does not want Reams to change its philosophy and process, and does not want staff to leave the firm.

Regent Forsyth asked for Wilshire's “rule of thumb” for underperformance; at what point does Wilshire suggest a change to its client? Mr. Friedberg responded that Wilshire does not have a set time period with regard to underperformance. Factors to be considered in monitoring a fund manager's underperformance are whether the underperformance is inconsistent with what Wilshire is being told by the fund manager. If Wilshire cannot identify the cause of the underperformance, and the underperformance is happening over longer periods of time, then Wilshire becomes very concerned. Reams' underperformance has occurred through a couple of cycles.

Mr. Friedberg presented information on Wilshire's review of the Regents' spending policy, as requested by the Banking Committee. He said the review included the ability to maintain the spending policy going forward based on normalized assets. The review

included a model which allowed the portfolio to pre-experience a multitude of events. He presented Wilshire's observations and recommendations based upon the review. Excluding the potential impact of future gifts, the real market value of both funds is likely to decrease slightly over the next 10 to 20 years, with the current spending policy and the current asset allocation mix. Growth in real spending levels is likely to remain flat to slightly decline based on the current spending policy. Using the current mix with the current 5 percent spending policy, he said there is a 48 to 49 percent chance of maintaining the real spending level and the real asset level. It is preferable for that number to be approximately 60 percent and, at least, above 50 percent. Decreasing the spending policy to 4-1/2 percent with the current mix would increase the likelihood of maintaining the real asset level to 55.6 percent. He stated that actual spending may be more with a 4-1/2 percent spending level with more assets versus a 5 percent spending level with a lesser amount of assets. Wilshire Associates would like to increase the probability of the fund maintaining real spending and real asset levels, and of achieving growth.

Regent Forsyth referred to Wilshire's assumptions that over an extended period of time fixed income will return 2.5 percent and equities 5.75 percent more than inflation. He then asked how those assumptions compare to performance over the last 10 and 20 years. Mr. Friedberg responded that the last 10 years have been somewhat different, but the overall result is in line with the assumption. Equities have been about 8.5 percent with inflation of about 2.25 percent to 3 percent. Mr. Friedberg then explained that while Wilshire does take into consideration what has happened in the past, the model uses a forward looking approach.

Regent Forsyth said he expected there would be a huge difference in the data if Wilshire's assumptions for expected returns and inflation were changed by one-half of one percent. He asked how Wilshire's numbers would compare over some period of time historically.

Regent Forsyth pointed out that if Wilshire looked back 30 years and used those average returns net of inflation it might present a very different picture. He then asked if Wilshire has looked at this compared with the current assumptions. Mr. Friedberg said that he had not looked at it but would expect it to be similar. Regent Forsyth said it would be helpful to look at it. There is a huge difference in just a quarter of a percent and the Banking Committee may come to a different conclusion with that information.

Vice President Madden stated that the fee structure needed to be built in to the assumptions.

Vice President True said it would be helpful to look at intervals, such as every decade, going back to 1929, to get a series of data that is net of inflation. Doing so might be a

simple test of reasonableness. Mr. Friedberg responded that Wilshire may have that information.

Regent Forsyth suggested that the data could be reviewed in rolling 10-year periods. He said the Banking Committee should look at the data in a number of different ways before considering whether to make any changes.

Mr. Friedberg stated that Wilshire's model is not a strictly forward-looking model. Wilshire's predictions are compared to those of the investment management community at large. The average is 8 percent. He said Wilshire could plug in data in a number of different ways to come up with expected returns, etc.

President Geoffroy stated that the discussion was very important and timely. He said Iowa State University's Foundation has had similar discussion and has, so far, elected to keep its current payout policy. He predicted that if a change is made to the payout policy for the endowment funds, there may be a ripple-down effect into the Foundation, as well.

President Newlin asked if the Foundation's payout policy is 5 percent. President Geoffroy responded affirmatively.

Vice President Madden stated that the ISU Foundation is hoping to make a decision this fall. In budget development for FY 2004, the Regent vice presidents for business and finance are using the 5 percent payout rate. He said their recommendation to the Banking Committee is that if there is to be a change in the payout rate, it be done by the end of this fall. By doing so, planning for the following fiscal year's budget can reflect the policy.

Regent Neil asked how long the spending policy has been 5 percent. Vice President True responded that the spending policy has been 5 percent with a three-year rolling average for at least a decade.

Regent Neil asked for the spending policies for other endowments. Mr. Friedberg responded that a NACUBO study was due to be released which would answer that question. He said he could provide the results of that study at another meeting of the Banking Committee.

President Geoffroy noted that the ISU Foundation has benchmarked against other foundations, almost all of which have had similar discussions. He said the average current payout is around 4.75 percent, and the numbers have been static for a period of time. The payout for public universities is usually higher than for private universities.

Vice President Madden referred to how the rolling average is calculated and he said the last three years were relatively low-performing quarters.

Regent Forsyth stated this is a critical issue that warrants much discussion. Given what is going on in the economy and in the legislature, and the concerns about rising tuition, the Banking Committee could make a strategic decision that the endowment portfolios may not keep up with inflation. The payout could be maintained for a period of time as a bridge or transition for operations of the institutions. If it had been known three years ago what was going to happen over the next three years, the Board and the institutions would have done some things differently. He stated that President Newlin and he have discussed and agreed that the next few years might look much like the last three years, which is not good. Therefore, from a strategic perspective, these funds should be used as part of managing a strategic transformation. He said the Banking Committee should get the best facts on which to make a strategic judgment.

Vice President True reminded the Banking Committee members of the time period within which to make changes, as requested by Vice President Madden.

Regent Forsyth stated that he has a paper which he will share with members of the Banking Committee. He said the worst three-year period in the history of the stock market was 1929 to 1932, when the market went down 64.2 percent. During the following three years, annualized returns on stocks were 22 percent and bonds were 2.2 percent. For the following five years annualized, stocks were 17.9 percent and bonds were 1.9 percent.

The period of time through March 2003 was the second worst three years in the history of the market, down 39.6 percent. Regent Forsyth stated that the Banking Committee has to have the greatest possible data base with which to make judgments.

Mr. Friedberg stated that, as requested, Wilshire had provided supplemental information projecting endowment performance had there been a more conservative policy mix. The information provided an examination of what returns would have been for the last 20 years with the current policy of 70/30 equity/fixed income compared to 60/40. He said that, as expected, in no situation would the funds be better off with a more conservative mix.

President Newlin asked if the next two years will be about the same as the last three years. Mr. Friedberg said he hoped that the coming years would be better than the last three years, and noted that was his opinion, not Wilshire's.

ACTION: Regent Arbisser stated the Banking Committee

(1) received the investment and cash management reports for the quarter ended March 31, 2003; and (2) received the spending policy review from Wilshire Associates, by general consent.

ANNUAL MASTER LEASE REPORT.

Associate Director Racki presented highlights of the annual master lease report. She stated the Board established a master lease agreement to provide short-term financing for real and personal property. The master lease program has operated through Wells Fargo as a result of Request for Proposal processes held in 1991, 1996, and 2001. The Board approves each financing utilizing the master lease agreement and Wells Fargo must agree to lease the property. Two leases totaling \$1.7 million have been entered into under the current agreement (effective January 1, 2002). Since the last report, two leases have been paid off.

Regent Neil asked if the financing provided through the master lease is at a fixed interest rate. Associate Director Racki responded that the interest rate is adjusted based on the Delphis index.

Mr. Fick said the Delphis index is a composite of tax-exempt interest rates in the market place. The index will vary as interest rates, in general, vary.

ACTION: Regent Arbisser stated the Banking Committee received the annual report on lease purchases under the master lease agreement, by general consent.

RESOLUTION AUTHORIZING THE EXPENDITURE OF BOND PROCEEDS (UNI).

Vice President Schellhardt presented the University of Northern Iowa's request to expend bond proceeds. He stated that in April 2002 the Board authorized the sale of \$4,890,000 Academic Building Revenue Refunding Bonds to refund outstanding maturities of 1991 bonds. Subsequent to the bond issuance, the State Treasurer expressed concern that refunding those bonds for which debt service payments were to be made from tobacco bond proceeds could adversely impact the tobacco bond financing of the state. Due to these concerns, the 2003 through 2007 maturities of the Series U.N.I. 1991 Bonds were not refunded with proceeds of the refunding bonds, but rather from an appropriation of tobacco bond proceeds. Expenditure of the proceeds not used to refund the 1991 bonds would require legislative authorization. As part of its 2003 legislative program, the Board requested authorization to expend the \$1,450,000 of the Series U.N.I. 2002 proceeds, which have been invested below the bond yield. The 2003 General Assembly passed legislation, which the Governor signed, allowing the University, with the authorization of the Board of Regents, to expend such proceeds to be used for renovation of facilities. He said the extra proceeds, which total \$1.45 million plus interest, would be used to fund the remodeling of space in Gilchrist Hall for the Integrated Student Services Center.

Mr. Bittle said the State Treasurer's concern was that if the purpose of the bonds was changed, the tobacco proceeds would be subject to audit. He noted that if the Board does not approve the expenditure of the bond proceeds, the money has to stay invested at a restricted yield. Doing so would present an "accounting nightmare" for the University.

MOTION:

Regent Downer moved to recommend that the Board adopt A Resolution authorizing the expenditure of bond proceeds from the issuance of \$4,890,000 Academic Building Revenue Refunding Bonds, Series U.N.I. 2002, dated May 1, 2002. Regent Arbisser seconded the motion.
MOTION CARRIED UNANIMOUSLY.

INTERNAL AUDIT REPORTS.

Director Elliott stated there were no new original audit reports this month. As a follow up to comments at the last Banking Committee meeting, she said the Board Office worked with the internal auditors to address the new reporting information in every audit, including target implementation dates, review dates, and report dates for each comment.

Director Elliott noted that next month the Banking Committee will be presented with the internal audit plans. The plans will include information on activities that have taken place over the last several years and will provide a measure of performance against the audit plans presented to the Banking Committee last year.

Regent Downer noted there were three expected completion dates of June 2003. He asked for the status of those audits. Director Elliott responded that audit reports are generally brought to the Banking Committee when it meets on the respective campus. Any internal audits that are ready for the July meeting will be presented in July because all three internal auditors will be in attendance.

ACTION: Regent Arbisser stated the Banking Committee received the report on the status of internal audit follow-up reports, by general consent.

OTHER BUSINESS.

Vice President Schellhardt stated that the University of Northern Iowa has an opportunity to reduce the tuition replacement appropriation, and asked for the Banking Committee's approval to do so.

Mr. Fick stated that refinancing the remaining outstanding Academic Building Revenue Refunding Bonds, Series U.N.I. 1993 would provide savings in excess of \$300,000 over the remaining life of the bonds. The interest rate was anticipated to be below 3 percent in the current market.

Mr. Bittle stated the Banking Committee was asked to adopt the usual resolution to set the sale.

MOTION: Regent Newlin moved to recommend that the Board adopt A Resolution authorizing the Executive Director to fix the date or dates for the sale of up to \$4,400,000 Academic Building Revenue Refunding Bonds, Series U.N.I. 2003A. Regent Downer seconded the motion. **MOTION CARRIED UNANIMOUSLY.**

ADJOURNMENT.

The meeting of the Regents Banking Committee adjourned at 9:33 a.m. on June 19, 2003.



Pamela M. Elliott
Director, Business and Finance



Gregory S. Nichols
Executive Director

bb/f.winword/603bank