MEMORANDUM

To: Banking Committee

From: Board Office

Subject: Fund Manager Changes

Date: February 9, 2004

Recommended Action:

Recommend the Board approve, for the institutional endowment portfolios:

1. The selection of Grantham, Mayo, Van Otterloo & Co. (GMO) as the new international equity fund manager.
2. The selection of Dodge and Cox as a new fixed income fund manager.
3. The transfer of Invesco's domestic equity portfolio to Vanguard, the Board's current large capitalization index fund manager.
4. An option as to whether an institution must split its fixed income portfolio, given its relative size and risk.
5. BlackRock as a contingent fixed income manager, should the selection of a new fixed income manager be necessary within the next year. The utilization of this manager would be subject to further approvals.

Executive Summary:

Termination of Fund Managers

At its December 2003 meeting, the Board moved to sever the investment relationships with Alliance Bernstein and Invesco.

- Alliance Bernstein managed the Board's international equity component of the endowment portfolio valued at $24.1 million at the end of the calendar year.
- Invesco managed both a domestic equity portfolio of $109.1 million and a fixed income portfolio of $88.9 million as of December 31, 2003.

Process

Institutional officials and Board Office staff worked with representatives from Wilshire Associates, the Board's investment advisor, to develop an expeditious process for replacing these fund managers.

Wilshire generated alternatives, including cost estimates, to transition the Board's identified endowment funds to new managers.

In consultation with the Banking Committee Chair, the following process was utilized:

- Wilshire Associates identified and provided evaluation summaries for small groups of qualified managers:
  - International equity fund managers.
  - Fixed income fund managers.
- A fund manager selection group, consisting of some Banking Committee members and representatives of the universities, the Board Office, and Wilshire Associates, conducted interviews of the top three fund managers in each category.
- Wilshire recommended the Board transition the domestic equity portfolio

to Vanguard, its current domestic equity index fund manager. This action would maintain compliance with the Board investment policies. In several months, the portfolio would be evaluated, with an emphasis on the domestic equity component.

Recommended Selection

The group recommends the following fund manager selections:

- Grantham, Mayo, Van Otterloo & Co. (GMO) as the new international equity fund manager.
- Dodge and Cox as a new fixed income fund manager.

In addition, the group concluded that:

- Splitting a relatively small fixed income component of the endowment portfolio between two managers may be inefficient and costly. Therefore, the group recommends that Board investment policies provide institutions with an option on whether the fixed income portfolio, given its relative size and risk, must be split between two fixed income managers.
- BlackRock, based on their interview, be considered a contingent fixed income manager, should a new fixed income manager be needed within the next year. This would eliminate the necessity for another in-depth selection process over a relatively short time frame.
- Domestic equities currently with Invesco should be transitioned to Vanguard, the Board's current large cap index portfolio fund manager.

The transition of all of these funds to the new managers would take place as soon as practical after Board approval.

Background and Analysis:

Previous Board Actions

At its December 2003 meeting, the Board moved to sever the investment relationships with two of its investment fund managers. These fund managers, Alliance Bernstein and Invesco, handled over $222.1 million of endowment fund investments as of December 31, 2003.

Evaluation of Options

To accomplish this task quickly, Wilshire identified the following objectives in evaluating transition options:

- Maintain Strategic Market Exposure
- Minimize Transaction Costs
- Maintain Institutional Quality Investment Management
- Avoid Unnecessary Risk
- Manage Process Efficiently with Minimal Disruption

Wilshire recommended that both Alliance Bernstein and Invesco be allowed to continue to actively manage their portfolios until the Board has hired replacement managers and the two firms were notified in writing to cease trading.

Wilshire recommended the Board conduct manager searches for the fixed income and international equity portfolios but transition Invesco's domestic equity portfolio to Vanguard, the Board's domestic equity index fund manager and not conduct a domestic equity fund manager search at this time.

Process

Wilshire Associates identified and provided evaluation summaries for small groups of qualified international equity fund managers and fixed income fund managers.

- Wilshire's manager selection process uses extensive technology and both qualitative and quantitative measures to identify managers who will successfully execute the fund's investment structure.
- Careful monitoring of managers by Wilshire at all times is essential to having reliable information to help locate suitable managers.
- Wilshire's manager selection process incorporates ongoing research as well as focused analysis. Wilshire maintains comprehensive databases on managers in all asset classes and has staff dedicated to researching investment managers.
- Wilshire consultants have experience in meeting new managers and viewing first hand manager relationships with Wilshire's existing clients.
- Wilshire also calculates and audits performance for client accounts on over 900 managers.

Selection Group

On Thursday, February 5, 2004, a group conducted interviews of the top three international equity fund managers and the top three fixed income fund managers.

The selection group consisted of representatives from the Banking Committee, the universities, the Board Office, and Wilshire Associates.

International Equity Fund Managers

The new international equity fund manager would replace Alliance Bernstein in managing that portfolio. As of December 31, 2003, the combined international equity portfolios managed by Alliance Bernstein totaled $24.1 million (4.1% of the combined endowment portfolio).

The group interviewed the following managers:

- Fidelity Management Trust Co.
- Grantham, Mayo, Van Otterloo & Co.
- New Star Institutional Managers, Ltd.

The group recommends Grantham, Mayo, Van Otterloo & Co. (GMO) as the Board's new international equity fund manager.

Fixed Income Managers

The new fixed income fund manager would replace Invesco as manager of the fixed income portfolio. As of December 31, 2003, the combined fixed income portfolios managed by Invesco totaled $88.9 million ($42.4 million or 13.6% of the combined endowment portfolio and $46.5 million or 49.6% of the SUI quasi-endowment portfolio).

The group interviewed the following fixed income fund managers:

- BlackRock
- Dodge & Cox
- Pacific Investment Management Company

The group recommends Dodge and Cox as a new fixed income fund manager for the Board's endowment investments.

The group also recommends that BlackRock be considered a contingent

fixed income manager, should a new fixed income manager be needed within the next year. The group believes that this would eliminate the need for another in-depth selection process over a relatively short time frame.

The group understands that Banking Committee and Board approvals would be necessary at a future point in time, prior to the institutions investing endowment assets in BlackRock.

Further, the group discussed the Board's manager allocations for fixed income endowment investments. Currently, the Board's asset allocation guidelines require:

- 30% of the total endowment portfolio be in fixed income funds, within established target ranges.
- The fixed income portfolio be split between two managers (15% of the total portfolio with each fixed income manager, within established target ranges).

The group concluded that splitting a relatively small fixed income component of the endowment portfolio between two managers may be inefficient and costly.

The group recommends that Board investment policies provide institutions with an option on whether the fixed income portfolio, given its relative size and risk, must be split between two fixed income fund managers.

Domestic Equity Fund Manager

The transition of the domestic equity fund to Vanguard would replace the domestic equity portfolio managed by Invesco, which totaled $109.1 million at December 31, 2003.

Vanguard was authorized as the Board's large capitalization index portfolio in September 2002. At the end of the calendar year, Vanguard managed $43.5 million (22.4%) of the Board's combined endowment portfolio.

This action would maintain compliance with the Board investment policies. In several months, the portfolio would be evaluated, with an emphasis on the domestic equity component.