

MEMORANDUM

To: Banking Committee
From: Board Office
Subject: Selection of New Fixed Income Manager
Date: June 1, 2001

Recommended Action:

Recommend the Board approve the selection of a new fixed income manager.

Executive Summary:

In May 2001, the Board authorized a search process for the selection of a new fixed income manager. Wilshire Associates identified three qualified fixed income manager candidates to be interviewed: BlackRock, Western Asset Management, and Reams Asset Management. A screening team consisting of Banking Committee members, and representatives of the universities and the Board Office will conduct the interviews. Since INVESCO currently handles all of the institutional endowments fixed income investments, they were invited to visit with the screening team prior to the interviews of the identified candidates.

The screening team is scheduled to conduct the interviews on the evening of June 5, 2001, and will present its recommendation for selection of the new fixed income manager at the Banking Committee meeting on June 12, 2001.

Background and Analysis:

In March 1989, the Board voted to obtain the services of external endowment fund managers to handle approximately \$31 million in endowment assets. At that time, the Banking Committee favored choosing one balanced manager (INVESCO) to handle approximately two-thirds of the endowment funds with another equity manager handling the remaining one-third. The Regents have made several changes in investment management firms since 1989. INVESCO has been a fund manager for the Board of Regents since the inception of utilizing external fund managers.

The University of Iowa requested that the Banking Committee authorize the addition of a second fixed income manager for the University to use for new deposits into its quasi-endowment portfolios.

The Board of Regents employs an investment advisor, Wilshire Associates, to guide its policy of active investment management. Wilshire recommended that the Board consider hiring a second fixed income manager to run a portion of the fixed income assets for the following reasons:

- The diversification benefit of hiring an additional manager will reduce the expected risk of the overall fixed income portfolio in three ways:
 - Expected total portfolio risk, as measured by the volatility of absolute returns, will be reduced.
 - Tracking error risk, as measured by the volatility of returns relative to the benchmark (also known as tracking error), will be reduced.
 - Organizational risk will be reduced by reducing exposure to INVESCO, who presently manages well over 80% of all Endowment and Quasi Pool assets.
- INVESCO's fixed income returns have lagged their benchmark over the past five-year period. For the five years ended December 31, 2000, INVESCO's fixed income return ranked in the 98th percentile (bottom 2%) of all core fixed income managers (see universe graph below).
- In addition, INVESCO is in the midst of restructuring their fixed income group, consolidating all portfolio management functions in Louisville, KY. This restructuring may prove to be a positive move in the long run, but is likely to be disruptive in the short run.

The University treasurers and the Board Office staff have worked with Mark Brubaker of Wilshire Associates to identify several fixed income managers that could be considered by the Board. Wilshire recommended that the Banking Committee interview up to three fixed income managers at its June meeting and select one from that group as a second fixed income manager for the universities to use for quasi-endowment management.

Wilshire suggested that BlackRock, Western Asset Management, and Reams Asset Management be considered to run a portion of the fixed income assets for the Board of Regents.