

MEMORANDUM

To: Banking Committee
From: Board Office
Subject: Fixed Income Manager
Date: May 7, 2001

Recommended Action:

1. Set interviews for fixed income management firms for the June Banking Committee meeting.
2. Recommend that the Board request a comprehensive review of its investment policy in relation to its endowment and quasi-endowment portfolios to evaluate asset allocation, risk management, benchmarks, and manager allocations.

Executive Summary:

The Regent institutions maintain two investment portfolios – operating and endowment. As last reported at the March Banking Committee meeting, the total of the Regent endowment portfolios, including the quasi-endowments, as of December 31, 2000, was \$289.7 million. Of the endowment portfolios, which totaled \$188.5 million, \$54.0 million was invested in fixed income (bonds). Of the two SUI quasi-endowments, which totaled \$101.2 million, \$73.1 million was invested in fixed income. All fund managers were within their respective Regent target allocations.

INVESCO, the Board's balanced portfolio fund manager since 1989, handles 84.2% or \$243.8 million of the Board's endowment and quasi-endowment portfolios. The fixed income investment totals \$127.1 million and represents 43.9% of the total Regent portfolios.

The University of Iowa has 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 University maintains two quasi-endowment portfolios: Quasi I - 50% fixed income and 50% equities, which totaled \$49.1 million and Quasi II - 100% fixed income, which totaled \$52.1 million.

After consultation with institutional officials, Wilshire Associates recommends that the Board of Regents consider hiring an additional fixed income manager to run a portion of the fixed income assets to reduce risk. Wilshire has also listed three fixed income management firms - BlackRock, Western Asset Management, and Reams Asset Management - to consider interviewing at its June meeting.

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.

ENDOWMENT/QUASI-ENDOWMENT PORTFOLIO

The Regent institutions currently maintain two primary endowment portfolios — the University of Iowa and Iowa State University. The University of Northern Iowa endowment portfolio is invested through the University of Iowa. The Iowa School for the Deaf and Iowa Braille and Sight Saving School endowment portfolios are invested through Iowa State University.

The University of Iowa also has two separately maintained quasi-endowment portfolios. Quasi I has an asset allocation mix of 50% equity and 50% fixed income investments, approved by the Board in June 1999. Quasi II, established in April 1998, allows the University of Iowa to retain a quasi-endowment pool with 100% fixed income investments. INVESCO manages both of these quasi-endowments.

Board policies permit endowment funds to be invested in investment grade, long-term fixed income securities and high quality equities that may produce both income and growth, with a targeted return to exceed inflation by 2% to 3% for bonds, 4% to 6% for domestic stocks, and 7% for foreign stocks (after exchange transactions and currency conversions).

ASSET ALLOCATION

In May 1997, the Banking Committee adopted a process to manage the endowment asset allocation close to the established targets and agreed to annually review the investment structure. In FY 1997, a benchmark with the asset mix of 60% domestic equities, 30% bonds, and 10% international equities was used to reflect the Regent asset allocation policy. In April 1999, the Board authorized a new asset allocation policy of 63% domestic equities, 30% fixed income, and 7% international equities beginning with the quarter ended September 30, 1999.

The Board's current target range for the asset allocation is plus or minus 10% of the established asset allocation policy for domestic equities and fixed income investment and plus or minus 3% for international equities. Institutional officials are authorized to maintain the appropriate portfolio asset allocations, and if, at the

end of a quarter, rebalancing is required, the institutional officials are to rebalance the portfolio during the following quarter.

In April 1999, the Board also approved the designation of specific manager allocations and ranges to assist the institutional officials in maintaining the Board's asset allocation policy.

Manager Allocation Policy

	<u>Target Range</u>	<u>Range</u>
INVESCO	74%	+/- 7%
Domestic Equities (stocks)	58% of 74%	+5% to -10% around 58%
Fixed Income (bonds)	42% of 74%	+10% to -5% around 42%
Seneca	19%	+/- 4%
Sanford Bernstein	7%	+/- 3%

The manager allocations generate the target endowment asset allocation when all managers are within policy targets (rounded to the nearest percent). The specific manager targets are designed to maintain the allocations within domestic equities for large-cap/small-cap mix approximately equal to the broad market (70% large-cap and 30% small-cap).

SECOND FIXED INCOME MANAGER

The University of Iowa has 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 to guide its policy of active investment management. Wilshire Associates has been the investment advisor to the Board and Regent institutions since May 1996.

Wilshire recommends 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 suggests 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. A summary table of annualized returns for each firm is provided below.

<i>Performance for Period Ending December 31, 2000</i>				
<u>Firm</u>	<u>1 Year</u>	<u>3 Year</u>	<u>5 Year</u>	<u>7 Year</u>
BlackRock	12.24	6.88	7.01	7.32
INVESCO*	11.77	6.53	5.80	6.96
Reams Asset Management	13.51	7.46	7.36	7.52
Western Asset Management	12.87	6.66	7.11	7.43
Lehman Gov't /Corp Index	11.84	6.20	6.23	6.53
Lehman Aggregate Index	11.63	6.36	6.46	6.68
* Performance is from Invesco's Core Fixed Income composite.				

There appears to be some uncertainty about the minimum dollar amount that firms would require to open a new fixed income account. The Board Office will work with Wilshire and the University of Iowa to research alternatives and the associated costs to achieve the initial minimum required deposit. The University of Iowa will present a plan to achieve any minimum required investment for the June Banking Committee meeting.

Benchmark Recommendation:

Wilshire also supports INVESCO's recommendation to change the fixed income benchmark from the Lehman Government/Corporate index to the Lehman Aggregate index. This index should be the benchmark for the portfolios of INVESCO, the proposed new manager and the total fixed income composite. The major difference between the two indexes is that the Aggregate includes mortgage-backed and asset-backed securities in addition to the government and corporate issues of the Government / Corporate index. There are two primary reasons to change benchmarks at this time.

First, with the U.S. government significantly reducing its deficit, the relative weight of corporate bonds in the Government / Corporate index is expected to increase dramatically, thereby increasing the credit risk embedded in this index. While the weight will increase in the Aggregate index as well, the impact is mitigated by the presence of the mortgage-backed and asset-backed securities.

Second, the Aggregate represents more of the total U.S. fixed income market and using it as the fixed income benchmark affords a manager more opportunity to add value and reduce risk.

The Board Office recommends that the suggested change in benchmark be considered in a comprehensive review of the Regent investment policy that would also include an evaluation of asset allocations, risk management, and manager allocations for both the endowment and quasi-endowment portfolios.

**Endowment Market Value of Institutional Portfolios
Accrual Basis
(Thousands of Dollars)
December 31, 2000**

	Endowment Market <u>Value</u>	Quasi- Endowment Market <u>Value</u>	1993 Trust Market <u>Value</u>	Total Market <u>Value</u>	<u>Percent of Total</u>
INVESCO					
SUI	\$69,288	\$101,237	\$ -	\$170,525	
ISU	<u>59,012</u>	<u>-</u>	<u>14,295</u>	<u>73,307</u>	
Total	\$128,300	\$101,237	\$14,295	\$243,832	84.2%
Seneca Capital Management					
SUI	16,767	-	-	16,767	
ISU	<u>13,808</u>	<u>-</u>	<u>3,287</u>	<u>17,095</u>	
Total	\$30,575	-	\$3,287	\$33,862	11.7%
Sanford Bernstein					
SUI	4,963	-	-	4,963	
ISU	<u>7,050</u>	<u>-</u>	<u>-</u>	<u>7,050</u>	
Total	\$12,013	-	-	\$12,013	4.1%
TOTAL					
SUI	91,018	\$101,237	-	192,255	
ISU	<u>79,870</u>	<u>-</u>	<u>17,582</u>	<u>97,452</u>	
Total	\$170,888	\$101,237	\$17,582	\$289,707	100.0%