BOARD OF REGENTS
STATE OF IOWA

AGENDA ITEM 8a
FEBRUARY 1-2, 2006

Contact: Pam Elliott Cain

INVESTMENT POLICY MODIFICATIONS AND IMPLEMENTATION

Action Requested: Consider recommending to the Board approval of the proposed investment policy changes and that full implementation within the asset allocation targets be accomplished by June 30, 2006.

Executive Summary:

At its September 2005 meeting, the Board received an extensive review and evaluation of its investment policy. The Board authorized changes that provided for additional asset classes and investment instruments and included specific definitions, uses, and guidelines for those instruments.

At its November 2005 meeting, the Board approved the selection of three new fund managers (high yield bonds, private equity, and real estate). In transitioning to the new fund managers with the contract specifications, a group consisting of institutional officials, legal counsel, Wilshire Associates, and Board Office staff determined that additional clarifications were needed in the Board's investment policy. The following summarizes the changes:

- Specify that futures and options contracts are not permissible investments.
- Include agents of the Commonfund as authorized investments.
- Limit the specific instruments for high yield bond investments.
- Include hiring procedures for custodians since the statutory mandates regarding custodians had been eliminated.

The Board's investment policy states that treasurers shall rebalance to the established targets during the quarter following the quarter ended whenever the asset allocation falls outside of the allowable range at the asset class level.

Because of the issues associated with the transitioning of investments to three new fund managers, the institutions have indicated that full implementation within the asset allocation targets may take until the second quarter of calendar year 2006. The Investment Committee is requested to recommend that the Board authorize an exception to its rebalancing policy until June 30, 2006.

7.04 Investment Activity

E. Operating Funds Investment Guidelines

3. General Restrictions and Other Provisions

e. The use of derivatives is permitted to facilitate risk management and to manage the cost of investing in publicly-traded stocks and bonds. A "derivative instrument" is defined as an instrument which derives its value, usefulness and marketability from an underlying instrument which represents direct ownership of an asset or a direct obligation of an issuer, i.e. a "spot" or cash market instrument. Derivatives should be used only in circumstances where they offer the most economic means of improving the risk/reward profile of the portfolio (the cost of the derivative versus the cost of constructing an equivalent position in traditional securities). Derivatives should not increase portfolio risk above the level that could be achieved in the portfolio using only traditional securities. The use of derivatives should not violate either the letter or spirit of the guidelines that limit exposure to market, sector, and security risks. Derivatives should not be used to effectively leverage the portfolio. Derivatives should not be used for speculative purposes (i.e. naked options). Examples of appropriate applications of derivative strategies include hedging interest rate and currency risk, maintaining exposure to a desired asset class while effecting asset allocation changes, and duration risk management. The extent to which a specific manager can use derivatives and specific derivative instruments may be further defined in that individual manager's guidelines. The individual manager guidelines may be more restrictive. <u>Futures and options contracts are not permissible investments.</u>

4. Authorized Investments (I.C. §§12B.10.6d and 12B.10A.5d)

l. The Common Fund for Non-Profit Organizations <u>and their agents</u>.

F. Endowment Fund s Investment Guidelines

4. Authorized Investments

d. Fixed Income.

2) Investment managers designated in writing by the investment committee may invest in below investment grade corporate bonds as defined by Standard and Poor's or its equivalent by Moody's or another Nationally Recognized Statistical Rating Organization. This type of investment may be made strategically as a fixed allocation or opportunistically by designated investment grade managers. <u>Investments shall be in limited liability investment vehicles, such as limited partnerships, limited liability corporations, and other pooled investment funds.</u> Additional credit quality restrictions may be made in the designated manager's investment guidelines.

G. Selection of External Providers

1. Investment Advisor <u>and Custodians</u>

Selection of external Investment Advisors <u>and custodians</u> shall take place in accordance with [Policy Manual Section 7.06.E.8], Professional Service Contracts. For the Investment Advisor, a competitive Request for Proposal (RFP) process shall occur no less than every five years.