

Investment Committee Memorandum
Board of Regents, State of Iowa

Subject: Proposed Changes for Domestic Equity Fund Managers and Manager Allocations

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Recommended Actions:

Recommend the Board approve, for the institutional endowment portfolios:

1. Selection of Goldman Sachs Asset Management as the new large capitalization domestic equity fund manager with an enhanced index philosophy.
 2. Selection of Lotsoff Capital Management as the large capitalization domestic equity fund manager with an active, fundamental, bottom-up philosophy.
 3. Termination of Vanguard, the Board's current large capitalization index fund manager. Modification to the manager allocation section of the Board's investment policy as included in Attachment A.
 4. Immediate modification to the manager allocation section of the Board's investment policy as included on page 4.
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Executive Summary:

Previous Board Actions At its December 2003 meeting, the Board moved to sever the investment relationships with Alliance Bernstein (international equity) and Invesco (a domestic equity portfolio and a fixed income portfolio).

In February 2004, the Board approved:

- The selection of a new international equity fund manager.
- The selection of a new fixed income fund manager.
- The temporary transfer of Invesco's domestic equity portfolio to Vanguard, the Board's large capitalization index fund manager.

Since the transition of the large capitalization domestic equity funds to Vanguard was temporary, Wilshire Associates was asked to identify and evaluate a small group of qualified large core equity fund managers.

Domestic Equity Considerations Institutional officials and Board Office staff worked with representatives from Wilshire Associates, the Board's investment advisor, to develop a strategy for handling the large capitalization domestic equity portion of the endowment portfolios.

Wilshire delineated search specifications for large core equity managers, which included typical characteristics, benchmarked to the S&P 500 Index, and three- to five-year performance expectations of at least 1% above the benchmark.

Wilshire Associates identified and provided evaluation summaries for a small group of qualified managers. A Regent fund manager selection group

conducted interviews of the top four domestic equity fund managers.

Recommendations The group recommends the selection of two active large capitalization domestic equity fund managers with differing investment philosophies: Goldman Sachs Asset Management and Lotsoff Capital Management. Each manager would be allocated an equal share of the large capitalization component of the endowment portfolios to optimize returns and limit risk.

To implement this recommendation:

- The relationship with Vanguard, an index fund manager with a passive investment philosophy, would need to be terminated.
- The Board's policy on manager allocations would need to be modified.

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.

- 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.

In February 2004, the Board:

- Selected Grantham, Mayo, Van Otterloo & Co. (GMO) as the new international equity fund manager.
- Selected Dodge and Cox as a new fixed income fund manager.
- Transferred Invesco's domestic equity portfolio to Vanguard, the Board's large capitalization index fund manager. (This action maintained compliance with the Board's investment policies. The portfolio would then be evaluated in several months, with an emphasis on the domestic equity component.)
- Provided the institutions with an option of splitting its fixed income portfolios between the two managers, given the relative size and risk of the portfolios.
- Selected BlackRock as a contingent fixed income manager, should a new fixed income manager be necessary within the next year, with the utilization of this manager subject to further approvals.

Domestic Equity Fund Manager The transition of the domestic equity fund to Vanguard replaced 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. Vanguard, as of June 30, 2004, managed \$147.9 million (37.1%) of the Board's combined endowment portfolio.

Process	<p>Since the transition of the domestic equity funds to Vanguard was temporary, Wilshire Associates was asked to identify and provide evaluation summaries for a small group of qualified active large core equity fund managers.</p> <ul style="list-style-type: none"> • Wilshire’s manager selection process: <ul style="list-style-type: none"> • Uses extensive technology and both qualitative and quantitative measures to identify managers who will successfully execute the fund’s investment structure. • 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. • Careful monitoring of managers by Wilshire at all times is essential to having reliable information to help locate suitable 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	<p>On Thursday, August 26, 2004, a Regent selection group conducted interviews of the top four large capitalization domestic equity fund managers. The selection group consisted of representatives from the Investment Committee, the universities, the Board Office, and Wilshire Associates.</p> <p>The group interviewed the following managers:</p> <ul style="list-style-type: none"> • Goldman Sachs Asset Management • AXA Rosenberg Investment Management LLC • UBS Global Asset Management • Lotsoff Capital Management
Recommendations	<p>The group recommends the selection of two domestic equity fund managers:</p> <ul style="list-style-type: none"> • Goldman Sachs Asset Management as the new domestic equity fund manager with an enhanced index philosophy. • Lotsoff Capital Management as the domestic equity fund manager with an active, fundamental, bottom-up philosophy. <p>Because of the differences in the investment philosophies, Wilshire was requested to determine the optimal allocation to the domestic equity fund managers. The optimization resulted in the following recommendation:</p> <ul style="list-style-type: none"> • Termination of Vanguard, the Board’s current large capitalization index fund manager. • An equal share of the large capitalization domestic equity portfolio between Lotsoff and Goldman.

Board Policy
Changes

The group recommends that the modifications to the Board's investment policy, noted below, be implemented immediately:

Chapter 7.03 Investment Activity

Section F. Endowment Funds Investment Guidelines

Subsection 5. Asset Allocation Guidelines

The allocation ranges shown below are intended to serve as a guide to the individual institutions in formulating asset mixes for their portfolios and may in the future be changed.

<u>Asset Class</u>	<u>Target</u>	<u>Allowable Range</u>	<u>Benchmark</u>
<u>U.S. Equities</u>	63%	58-68%	Wilshire 5000
Large Cap Core <u>(Active)</u>	24 35	19-29 30-40	S&P 500 Index
Large Cap <u>Enhanced</u> Index	24 13	19-29 10-16	S&P 500 Index
Mid Cap Growth	10	8-12	Russell 2500 Growth
Small Cap Value	5	3-7	Russell 2500 Value
<u>U.S. Bonds</u>	30%	25-35%	
Core	30	25-35	Lehman Aggregate
<u>International Equities</u>	7%	4-10%	MSCI EAFE
Other *	0%	0-15%	

* Other asset classes to be added in the future.