Contact: Patrice Sayre

MINUTES OF SEPTEMBER 17, 2008
AUDIT/COMPLIANCE AND INVESTMENT COMMITTEE
BOARD OF REGENTS, STATE OF IOWA
MAUCKER UNION, UNIVERSITY OF NORTHERN IOWA
IOWA CITY, IOWA

Committee Members

Jack Evans (Chair)	Michael Gartner	David Miles
Bonnie Campbell	Ruth Harkin	Rose Vasquez
Robert Downer	Craig Lang	

Staff Members
Bob Donley, Patrice Sayre

Others
David Vaudt, Andrew Nielsen, Office of Auditor of State
Mark Brubaker, Mike Dudkowski, Wilshire Consulting

The corresponding docket memorandum for each agenda item, an integral component of the minutes, is available on the Board of Regents website: www2.state.ia.us/regents. Copies of these memoranda can also be obtained from the Board Office by calling 515-281-3934.

Chair Evans called the meeting to order at 1:52 p.m.

Approve Minutes from August 6, 2008, Committee Meeting

➢ MOVED by LANG, SECONDED by HARKIN, to approve the minutes of the August 6, 2008, meeting. Regent Downer asked for a correction on the discussion of the internal audit plan. The following sentence should have read as follows: Regent Downer asked about the size of the internal audit staffs at each of the three universities and stated that in regard to the size of the universities, staff appears light *at Iowa State University* (correction in italics). Motion APPROVED as corrected by GENERAL CONSENT.

Receive Report on Investment and Cash Management Report for the Quarter ended June 30, 2008

Mark Brubaker of Wilshire Consulting covered the report, but first talked about recent performance and market issues. As a backdrop, Mr. Brubaker said that we first saw the deterioration in the housing market in the third quarter of 2007 reflected in declining market values in non-agency mortgage-backed securities, collateralized debt obligations; a lot of the instruments that fixed income managers had held and portrayed as being safe and a good risk/reward relationship in terms of return. That continued through the end of 2007, at which point it got worse beginning in the first quarter of 2008, and preceded thus far up through yesterday. The first fallout from the declining real estate market was Bear Sterns in March when the feds and treasury organized a buyout by JP Morgan. A lot of people hoped that was the end of it; it turns out to just have been the beginning. From that point in time, Bank of America acquired Countrywide; Fannie Mae and Freddie Mac went into government conservatorship two weeks ago. This past weekend Lehman filed Chapter 11; Merrill Lynch agreed to be acquired by Bank of America and AIG just Tuesday night received an $85 billion loan from the US government. As part of that loan, the government received an 80% stake in the firm in the form of warrants and is collecting a rate of LIBOR plus 850 basis points on that loan. Some would call it a bail out, but Brubaker thinks the government is poised to make some money on that transaction, barring further deterioration - which is the key. As of this morning, markets are down about 180 points, during lunch they were down as much as 350 points. More importantly, Morgan Stanley has fallen 40%; Goldman Sachs is down roughly 30%. The concern is can these independent investment banks survive with leverage ratios of 30:1? Nobody really knows the nature of the securities they hold on their balance sheets and how risky they may ultimately be. At end of the day what we have is a crisis of confidence. Even if the securities held at Morgan Stanley and Goldman are good, if people lose confidence that has significant ramifications on their abilities to do business on an ongoing basis.

Mr. Brubaker went on to say that we are experiencing a crisis of confidence, but the question for this committee is what does this mean to the Regents' portfolio? There is some exposure, though not necessarily directly, to many of the firms above named through the debt market. We do not have meaningful exposure there, but it has had an indirect impact on the portfolio as spreads have widened. A lot of the fixed income products have underperformed as a result. In addition, this indirectly impacts equity managers. In the long term, there will be fewer broker dealers. People talk about liquidity needing to return to the market and things to normalize. "Normal" could be costlier trading; as managers make transactions and we make transitions, the cost of doing business will increase. For clients using swaps, derivatives, securities lending, etc., there will be more impact; Regents don't have these exposures. However, we do have Lehman Brothers as one of the Private Equity managers - that is a concern. Wilshire is in regular contact with Lehman and thinks the potential outcome from all this could be positive for this group. They have always been fairly independent and our expectation is that the asset management business will be bought.

Mike Dudkowski of Wilshire Consulting added that the group that manages money for the universities is part of Lehman Asset Managements, which is separate from Lehman Holding Inc. The assets are segregated, and the asset management group is not subject to the general creditors of Lehman Holdings.

Mr. Brubaker said he expects more positive news coming from that than negative. In the meantime, assets are safe as there is no tie-in with Lehman Holding Inc creditors.

A couple of quick market backdrops - one of the largest money market funds had 1.2% of their funds in Lehman debt securities and "broke the buck". The public has always considered money markets to be very safe and very liquid and this case brings to the forefront the importance of digging down and understanding the risk embedded in every portfolio. A couple of positives: the dollar has strengthened, oil prices have declined, and as a result, inflation declined in August for the first time in two years. Everybody in the market hopes this is the "last shoe".

Looking at the quarterly return for June 30, 2008, returns were down 1.3%; down 8.3% for the year. That compares unfavorably to the policy index which was down 5.3%. This is the widest margin of underperformance seen in this portfolio since Wilshire has been working with the Regents and probably prior to that. US Equity managers were the primary drivers of the decrease, one of whom, Goldman Sachs has been terminated. The two small cap managers, LSV and Artisan, underperformed by very wide margins over the past twelve months. On the Fixed Income side, results were down relative to the benchmark, especially with Dodge and Cox. The median decrease for endowment funds was 5% over the year. Brubaker took the Board through exhibits in the Investment and Cash Management Report.

As to the operating fund, and this issue came up about six month ago when Wilshire did the reviews as well, managers are underperforming their respective benchmarks. The degree of underperformance is almost directly proportionate to the exposure they've had to collateralized debt obligations. The Commonfund and intermediate term fund for the one year period is up 0.6% vs 7.3% for the benchmark - a very disappointing result. Wellington had a similar story; likewise for Blackrock. These returns are reflective of the range of returns seen from all active managers. Most, if not all, active managers in intermediate duration space, as well as market duration space, tend to overweight spread products; corporates, mortgage securities and asset-backed securities, and as a result we are seeing negative returns relative to the benchmark. An alternative asset allocation strategy, being presented for the University of Iowa account today, should help temper this.

Within the portfolio, LSV is on watch. They continue to underperform - down 6.8% vs. benchmark of -1.2%. Nothing has changed since Wilshire last met with them. Wilshire reviewed holdings in portfolio, and names in the portfolio are quite attractive but not measuring up in small cap value space. As to Artisan, Regents and Wilshire will be having manager meetings next month and Artisan is one of those firms that will present their portfolio. There are two causes for poor performance – 1) a lower energy exposure (which has been up 26%) than the benchmark, and 2) owning a lot of industrials, which have not performed well. Wilshire reserves judgment on Artisan until the October interviews, but there is concern. One mitigating factor for Artisans is that the stocks that have been driving their underperformance are not traditional strengths of small cap growth managers; energy and industrial stocks.

Chair Evans asked Wilshire to comment on Wilshire's policy, as Regents have been with the underperforming funds under discussion for some time.

Mr. Brubaker stated Regents have been with LSV for over five years and with Artisan for three plus years. He further said Wilshire takes the long term view – give the manager at least three years. However, the magnitude of underperformance we're seeing is meaningful. One of the things we are wrestling with in the market environment over the past twelve months is the connection between equity results and fixed income markets; the linkage there is the vast amount of trading controlled by multi-strategy hedge funds selling liquid securities to de-lever – a lot of long equity positions were sold to cover that. Wilshire has no hard evidence of this fact, but when you look at stocks that outperformed this fiscal year, stocks that had no earnings, negative growth rates and very high multiples were the ones that performed best. In the case of Artisan, energy was a big driver in the small cap growth index when that has not been a typical factor. This is not making excuses for these managers; they must be looked at case by case. Wilshire may terminate a manager short of 18 months if something in the portfolio doesn't jibe with the strategy for hiring them. Upcoming fund manager reviews will be key in digging down and understanding reasons for underperformance as the firm names in Regents' portfolios have quality earnings at low prices. Artisan will be closely reviewed as they are at the three year window.

Brubaker went on to report on Fixed Income managers, stating that Reams is in the top quartile of all managers from inception. He reminded the Regents that for the first two and a half years, Reams was consistently under the benchmark; part of the reason for that is they were exercising more caution that peer managers and that strategy paid off. Dodge and Cox looks disappointing at the one year mark. Finally, the Real Estate portfolio is fine, but is difficult to evaluate on a short term basis. Private equity is only 1.4% of the portfolio but has been disappointing in the past twelve months.

To summarize performance, Brubaker said the market gave -5.3% return, but managers contributed the rest of the poor performance. He feels a lot of the securities in the portfolios are potentially good and advocates staying the course for the most part. Wilshire has confidence in Dodge and Cox, Reams, and GMO, but the two small cap equity managers, Artisan and LSV, have to be reassessed and a decision made.

Chair Evans asked Wilshire to go over Private Equity numbers again as the one year numbers vs the quarter seem so different – down 51% for the year, but up 16% for the quarter. Mr. Brubaker said as those funds ramp up, the first thing that happens is the manager takes the fee, so the fees based on committed capitals cause negatives in the early period. Wilshire asked all to turn to page 10 showing the Internal Rate of Return, which adjusts for the cash flows; the result is 1.1% compared to benchmark of Investible Wilshire 5000 which was a -6.2%, and reflects opportunity cost. Brubaker feels the Private Equity portfolio, notwithstanding Lehman, is in an OK position.

Receive reports and recommendations on New Investment Options, Asset Allocations and Fund Manager Selection.
Mike Dudkowski led the discussion on New Investment Options, Asset Allocations and Fund Manager Selection saying he was bringing a formal recommendation for the long term endowment pool and would highlight the necessity and importance of a long term asset allocation focus. The common theme on the endowment pool, as well as operating funds, is to broaden diversification as well as pursue return. This should help in times like these. This report is the culmination of a lot of work by the universities' staff.

Regent Vasquez asked what, if anything, we could have done differently or were we doing what everybody else was in regards to our investment.

Mr. Brubaker said that almost at every point, when things deteriorated at the end of calendar year 2007, it took everybody by surprise. Every Fixed Income manager Wilshire talked to did not see it coming and when clients began to want to lower risk exposure, those managers were resistant. In hindsight, certain securities could have been sold. Even today, it continues to catch people off guard with the speed and magnitude of the market deterioration. Brubaker still thinks that at the end of the day the best approach is a long-term strategic view and to avoid fear reactions; rebalance and be willing to take money out of lower risk asset classes and put them into underperforming assets to get back to the policy target.

Mr. Dudkowski said he would come back to the asset allocation plan after walking the Board through some of the process undergone to develop the new plan. He pointed out, using long-term perspective forecasts of 10+ years, that the objectives were 1) growth of real market value and 2) ability to provide consistent support of institutional programs by maintaining real spending power. Pointing out data presented on page 11 of the report, Dudkowski highlighted the current asset allocation against some differences relative to NACUBO asset allocation, noting that the greatest difference in the Regents exhibit is greater than average allocation to Fixed Income and the absence of hedge funds and alpha-type investments; there are smaller differences in Private Equity and Real Assets. The Regents target of 5% for both these classes is below most other larger endowments and foundations. Wilshire will recommend broadening out that exposure in magnitude and by type into other Real Asset types, including Natural Resources.

Dudkowski turned to page 18, showing efficient frontiers as Wilshire evaluated several scenarios, including the current Regent one (Portfolio A). He walked the Board through other sections of the report. Part of the evaluation was looking at spending policy and how various portfolios achieve spending for program support, universally using 6% spending, for common analyses. Included was data on other universities for comparative purposes.

President Miles asked if the spending policies being used for these endowment portfolios were the same as the universities' foundations. Warren Madden and Doug True both responded that they were. President Miles queried further about how long the spending policies had been in place at 6%. True said the administrative rate came about 6-8 years ago when the university decided to follow the same policy as the foundation; the 5% program spending policy has been in place maybe 20 years.

President Miles requested information on peers, NACUBO and high performers as to spending rates, saying 6% feels aggressive. Wilshire agreed to get data to respond.

Mr. Dudkowski called attention to sensitivity analysis, found on page 30, noting the recommendation for asset mix in all cases represents an improvement in meeting the objective of real spending and real market value over the current asset mix. Wilshire believes there is a reasonably high probability of meeting those objectives. On page 32, Portfolio C is the recommended asset allocation plan. The primary difference is a decrease in total public equity from 60% to 50%; addition of global market structure to eliminate bias towards U.S. Equities, splitting evenly between non-U.S and U.S (Wilshire sees this balance occurring in foundation and pension funds); no change in Fixed Income – 30%; Private Equity will change from 5% to 10%; and in Private Real Assets, an increase from 5% to 10%, which includes broadening exposure beyond just real estate to other real asset types, which could include natural resources, timber, infrastructure, and other items that have those characteristics that generate moderate returns and some protection against inflation. There will be no allocation to hedge funds at this time, but there may be future discussion on these funds, including more education on the topic with the Audit/Compliance and Investment Committee. The report included implementation steps and a proposed timeline for informational purposes.

Chair Jack Evans asked if there were any comments from the university vice presidents of business.

Mr. True stated the university financial staff agrees with the portfolio proposal, having spent a lot of time with Board staff and Wilshire advisors. True noted that hedge funds as a future issue is the biggest unknown, but that it should not be taken all the way "off the table" and that he would like to proceed with the plan Wilshire recommends. Mr. Madden agreed with Mr. True's comments and noted that to the benefit of the ISU Foundation, hedge funds are a valuable component that helped reduce volatility. He would also want to move forward with discussion on hedge funds as a next step after adopting this plan since they may be something that could have dampened the volatility of what has happened in the market recently.

Mr. Schellhardt agreed with his peers, saying that the UNI Foundation also uses hedge fund to give more diversification.

President Miles would like information on NACUBO peers and asked if Wilshire has the ability to give a report on the aggregate performance of leading endowments over a longer period of time, or those endowments that are considered to be leaders. He notes that this recommendation moves us towards what peers are doing, but that there are endowments that are significantly outperforming the median over a period of time. He would like Wilshire to report on this.

Mr. Brubaker said he could obtain that data. He went on to say that when talking about top performers, such as Harvard and Yale, there is a tactical component, which differs from most endowments in the $2 billion and under level. These institutions change the asset policy mix from one year to the next. That being said, Wilshire can get the current mix for comparative purposes.

President Miles wants to get an aspirational comparison, rather than just a median of what others are doing, and understands that one must be very cautious in drawing conclusions from the data as to replicability. One other thing President Miles noted is that, in NACUBO $500 million - $1 billion endowments, almost 18% is allocated to hedge funds and he would like to get a better understanding of where Regents universities wish to go with hedge funds, expressing surprise that the recommendation for now is zero.

Mr. True reported that conversations have been held with the Attorney General. It is not clear if we have the underlying statutory authority; financial staff thinks that deserves more attention. During the next legislative session, we may address these apparent barriers. We must also continue to educate ourselves to know what forms of hedge funds work for us and that we are capable of doing the due diligence that is required.

Regent Lang said he was not sure we've seen the end on hedge funds exposure and is not sure we're acting quickly enough. On non-U.S. equities, he noted there have been good run-ups on those kinds of securities to this point, but globally, many times those securities follow U.S. equities. If we are in a position where the U.S. causes a worldwide recession because of our current situation, he is concerned about moving to an equal share of US/non-US Equity.

Mr. Brubaker echoed Regent Lang's statements, calling them "spot on". The question is if that is a tactical view or a long term strategic one. Foreign stocks underperformed U.S. stocks by a wide margin this quarter. Wilshire's rationale for a 50/50 mix is based on the fact that markets are more inter-related, and therefore, the distinction between U.S. and non-U.S. stocks is less broad. In an unconstrained model, more non-U.S. stock would be picked. This recommendation gives a global mix and Wilshire believes that in the long term, an optimal mix.

Regent Lang noted that some have called what is going on in the markets now "psychological contagion". If things are unconstrained, one might not really have the ability to select like Harvard did with energy. There are certain things that are a sure bet within that, but it is unknown what occurs in a global market.

Mr. Brubaker thinks Harvard and Yale adopted a more global view, and didn't know if they do anything tactical as far as shifting those allocations. He feels increasing real asset allocation, as well as private equity allocation, gives us some flexibility and opportunity to be a buyer as well as a seller.

Mr. Dudkowski discussed non-endowment assets at the University of Iowa managed in the short-term bond fund, highlighting objectives to identify portfolio alternatives to increase return without compromising key objectives in terms of safety of principal, liquidity and obtaining prudent levels of return given the risk level. Wilshire ultimately arrived at a diversified pool with statistical asset mix targets in terms of rebalancing and implementation vehicles as represented by low-cost Vanguard index funds. Walking the Regents through the report, Dudkowski noted efficient frontiers graphs and discussed how Wilshire arrived at the recommended Portfolio C; 40% cash, 30% core Fixed Income, 5% high yield, 10% Treasury-inflation protected securities, 10% U.S/Non U.S., and 5% REITS. This is a fairly conservative investment in equities, but will give a better return with a reduction of risk. Dudkowski also pointed out that Wilshire stress-tested these portfolios and verified that Portfolio C is the best alternative given the risk tolerance.

Mr. True said he agreed completely with what has been outlined, having worked on this project for about a year, this strategy has minimum risk and a good return. He asked for stress testing over current and historical data, and using university advisors as well as Wilshire, feels this is the best compromise. The only other question is implementation. If the Board approves this proposal, SUI will work with Wilshire and the Board office to do this prudently and take advantage of this opportunity over the next several months.

Chair Evans said he would entertain a motion to approve the revised investment policy to include asset allocation decisions for the diversified investment pool for University of Iowa and endowment pools for all three institutions.

Mr. Dudkowski noted one additional item that, consistent with expanding the Real Estate sector of the endowment fund, there is an opportunity to invest in the Commonfund Natural Resources program . Wilshire recommends, per the memo included in the Board packet, that approval be given at tomorrow's Board meeting as it is a timely matter whereby the fund would close.

Chair Evans asked if Regent Downer would consider this part of his motion; Downer agreed.

- MOVED by DOWNER, SECONDED by CAMPBELL, to receive the reports on New Investment Options, Asset Allocation and Fund Manager Selection and adopt the recommendations contained therein, as well as the revised Regent Investment Policy. MOTION APPROVED by CONSENSUS.

Receive the FY 2007 State Audit Reports
Auditor of State David Vaudt discussed the FY 2007 reports issued by his office, including the Comprehensive Annual Financial Report (CAFR), the Single Audit Report (SAR), and separate audits on each of the institutions and the Board Office; all were issued an unqualified opinion.

Auditor Vaudt reported that nothing rose to the level of comment to be brought to the attention of this Committee. Each year, the Auditor's Office works with Todd Stewart, Internal Audit Director, to combine audit plans and leverage the work each department does.

Chair Evans noted that Todd Stewart and he had reviewed all of the reports presented.

Auditor Vaudt thanked Regents institutional personnel for their cooperation and assistance. He stated that he will try to attend Board of Regents meetings as frequently as possible.

President Miles thanked Auditor Vaudt for all the work done by the Auditor of State's Office on behalf of the Regents enterprise and special efforts to attend Board of Regents meetings.

- Committee received the report by GENERAL CONSENSUS

Approve the Investment and Cash Management Report for the Quarter Ended June 30, 2008
Chair Evans, as an administrative item, entertained a motion to approve the Investment and Cash Management Report for the Quarter Ended June 30, 2008

- MOVED by LANG, SECONDED by MILES to accept the Investment and Cash Management Report. MOTION APPROVED by CONSENSUS.

Receive the Annual Review of Banking and Broker Relationships
Patrice Sayre stated that on an annual basis, the Board looks at brokerage firms and financial institutions approved by the Board of Regents and receives institutional requests to make changes to that list of institutions.

Regent Miles noted that in terms of the safety and security of the various bank depositories the Regents use, as a public body the Regents have an additional layer of protection for assets.

Mr. True corroborated this, saying as these are public funds, the banking industry supports a protection system managed by the State Treasurer's Office that is not available to private funds. In case of a problem with the bank, and public funds are lost as a result, statutory provisions were put in place 15-20 years ago following the Iowa Fund scandal in which some counties lost money.

Mr. Madden added that the balances are insured to the full amount, not just the FDIC level.

Regent Gartner noted that as Regents may serve on various financial institutions, that should be disclosed as a conflict of interest and footnoted on the Banking and Broker Relationships report.

Regent Harkin asked how banks are chosen and how often reviews are done. Mr. Madden said that proposals are solicited asking for data on rates, prices, level of service and such – similar to proposals for other services via a competitive bidding process. Generally banking requests for services are done every 5 years unless some an issue arises that calls for a shorter interlude.

Regent Downer noted that Iowa State Bank and Trust has become Midwest One Bank due to merger on about August 11.

Chair Evans entertained a motion to approve the revised list of Banking and Broker Relationships.

- ➢ MOVED by GARTNER, SECONDED by HARKIN to approve the revised list of Banking and Broker Relationships. MOTION APPROVED by CONSENSUS.

Meeting adjourned at 3:10 p.m.