BOARD OF REGENTS
INVESTMENT COMMITTEE

June 15, 2004

Persons in attendance:

Committee members: David Neil (Chair), Mary Ellen Becker, John Forsyth (ex officio), Owen Newlin, Jenny Rokes.

Others: Robert Downer, Sue Nieland (arrived at 2:30 p.m.), Greg Nichols, Pam Elliott, Tom Evans, Deb Hendrickson, Joan Racki, Tony Girardi, Elaine Newell, Barb Boose, Dotti Hale, Barb Briggle, David Skorton, Doug True, Cynthia Bartels, Gregory Geoffroy, Warren Madden, Joan Thompson, Robert Koob, Tom Schellhardt, Gary Shontz, Jeanne Prickett, Jim Heuer, Luann Woodward, Marc Friedberg, Mark Brubaker.

Regent Neil called the meeting to order at 1:55 p.m.

Draft Committee Purpose and Responsibilities

Committee members discussed the responsibilities of the Investment Committee, as approved by the Board of Regents. No changes were recommended.

Draft Committee Work Plan

Regent Neil pointed out that Committee members were presented with a revised work plan which corrected the dates presented in the original document.

MOTION: Regent Becker moved to adopt the draft Committee work plan, as revised. Regent Rokes seconded the motion. MOTION CARRIED UNANIMOUSLY.

Investment and Cash Management Report for the Quarter Ended March 31, 2004

Messrs. Brubaker and Friedberg of Wilshire Associates, the Board's investment advisor, presented a summary of the quarterly investment and cash management report.

President Forsyth pointed out that asset allocation had not had much impact on the portfolio performance since inception. However, over the last five years, asset allocation had a significant impact.

Regent Neil asked why, when active management was being utilized, the returns were not keeping up with the index.

Mr. Friedberg said the portfolios have had a slight passive weight to U.S. equities. In the small cap, international and fixed income segments of the market, active managers have consistently added value. In the large cap market, the index has often outperformed most equity managers. Wilshire Associates prefers active management in small caps, international, and fixed income, and either passive or structured products for the large cap segment. Structured products are strategies with lower excess risk relative to the benchmark.

Mr. Brubaker stated that the last three-year period has been a particularly rough period. However, the managers outperformed so strongly in the late-1990s that the five-year number is good. With active management, there are going to be cycles when managers outperform and when managers underperform. Hiring managers with complementary styles provides a diversification benefit. He said Seneca has been the primary driver of the portfolios' underperformance in the last three years.

President Forsyth addressed the performance of Wilshire Associates as investment advisor. What should the Committee focus on when it decides whether to seek new advisors? Mr. Brubaker responded that there are numerous measures. One of the best ways for an investment advisor to evaluate investment managers is a measurement referred to as information ratio. The baseline position is to index everything. If one uses active management, one should be compensated for the additional risk. Wilshire measures that risk by tracking the volatility of the portfolio relative to the index.

President Forsyth questioned whether the services of Wilshire Associates would be needed if everything was indexed. Mr. Brubaker responded that Wilshire Associates would look at the tracking error of the manager versus the index. For example, if a manager has a tracking error of 4%, which means its volatility relative to the index is moderate, and its excess return is 2% over a five-year period. The information ratio would be the excess return over the excess risk, or 0.5. Other forms of assessment include setting targets for asset classes and individual managers on a total fund level. He said the Board of Regents' policy index is appropriate for the Board long term. How the portfolios are performing relative to the policy index is the primary driver.

Mr. Friedberg pointed out that Wilshire Associates is probably one of only a few consultants who will recommend passive management because many people have the view that consultants are not needed if the portfolio is 100% indexed. However, manager selection is only 3% to 5% of performance. Other factors include asset allocation, investment structure, policy development, measurement and monitoring. Although it might make Wilshire Associates less needed, the firm believes that passive management in certain segments of the market does make sense.

President Forsyth asked about measurement criteria. Mr. Brubaker responded that Wilshire Associates representatives can provide formal measurement criteria with expectations for asset classes.

Mr. Brubaker concluded his presentation by reporting on the Securities & Exchange Commission (SEC) investigation of Wellington. He assured the Committee members that they will be contacted immediately if more concrete information comes out about the SEC investigation.

Vice President True asked if Reams was off Wilshire's "watch list" due to prior poor performance. Mr. Friedberg responded that Reams is not on the watch list, yet Wilshire Associates continues to monitor Reams' performance closely. Reams is performing pretty well and appeared to be taking a lot of its "bets" off the "table". Reams does not have any significant positions in terms of yield curve or structure. Reams' portfolio has a lower duration than the benchmark and is light on credit.

Vice President True referred to the movement of a large segment of domestic equity to Vanguard, which was an index manager for the Board. He asked if Wilshire Associates had a specific recommendation about proceeding to allocate the full amount of the domestic equity to Vanguard.

Mr. Friedberg responded that, for the time being, especially with all of the SEC investigations, Vanguard is a good place to keep large cap domestic equities until everything is sorted out. Wilshire's long-term recommendation would be to maintain all or at least a large portion of large cap funds in the index. If the Committee feels that active management is more appropriate, Wilshire had previously presented a short list of candidates that could be updated. The current recommendation, however, would be to maintain the funds in the index.

Regent Neil asked for Wilshire's recommendation on percentage. Mr. Friedberg responded that Wilshire would be comfortable with as much as 100% of the large cap equities indexed or passively managed. Wilshire Associates is a very strong advocate of a large portion of the large cap segment of the portfolio being indexed. The total percentage of assets that are managed passively is dependent on the active managers selected and the desired level of active risk.

Director Elliott noted that the Board's policy currently specifies 35% of the endowment portfolio in large cap actively managed equities, and 13% in the large cap index fund.

President Forsyth pointed out that the materials for this agenda item indicated another manager will be selected by the September meeting. Mr. Friedberg stated that his understanding was that the matter was going to be revisited in September after two quarters had passed and further information was available regarding SEC investigations.

Mr. Brubaker stated that if the Committee desires more active risk in the large cap, Wilshire Associates has identified suitable firms for consideration. The allocations would likely be dependent on the volatility of the firm that is selected and the amount of risk that is determined to be acceptable. He stated the active managers' fees can vary from 45 to 75 basis points in a large cap portfolio. Indexing fees are currently around 8 basis points.

President Forsyth asked to hear from the three chief financial officers. He noted that he is a member of a number of investment committees and none are 100% indexed in large cap. He stated that there are managers who regularly beat the index.

Vice President True stated that indexing, in part, can serve as a stable base upon which a portfolio operates. He favors a split of the large cap between active management and indexing. He noted that a previous Board of Regents' philosophy was to utilize an active manager who can protect the portfolio in a down market, not one that would exceed expectations in an up market.

Vice President Madden expressed support for a portion of the portfolio being actively managed.

President Forsyth questioned whether it would be reasonable to review the allocation between fixed and indexed in the large cap portion of the portfolio, and to start the review of large cap managers. The intent would be to resolve both issues yet this year. If the portfolios are out of policy compliance, the Committee might have to take some action. Manager review could take place between now and September.

Vice President Madden questioned whether the Committee members want to be part of an interview process of managers. President Forsyth suggested that Committee members who are interested and available could participate.

Regent Neil suggested that at the September meeting the Committee members consider revising the investment policy and begin the selection process for a new manager.

President Forsyth said both activities could be done in parallel fashion.

The Committee members discussed how to proceed on the two matters.

Regent Neil suggested that someone make a motion to split the large cap portion of the portfolios to have less than 100% indexed, for the Board Office and the institutions to propose a reasonable percentage of the total to split, and to begin the process of selecting a new manager.

Mr. Brubaker offered for Wilshire Associates to provide information for the Committee's consideration which indicates the risk characteristics of the top firms and how those characteristics would blend with the Board's other fund managers, as part as the search process. Wilshire Associates could recommend appropriate ranges if a particular manager is selected.

Regent Neil requested a motion to start the search process for a new active manager for a portion of the portfolio.

MOTION: Regent Becker moved to select a new active large capitalization equity portfolio manager in September. Regent Newlin seconded the motion. MOTION CARRIED UNANIMOUSLY.

Regent Neil directed the Board Office to notify the Committee members when and if a meeting is scheduled to interview large cap fund managers.

Meeting adjourned at 3:00 p.m.

Pamela M. Elliott
Director, Business and Finance

Gregory S. Nichols
Executive Director