
# Treasurer's Annual Report

One hundred and thirty-sixth fiscal year

University of California • 2003-2004

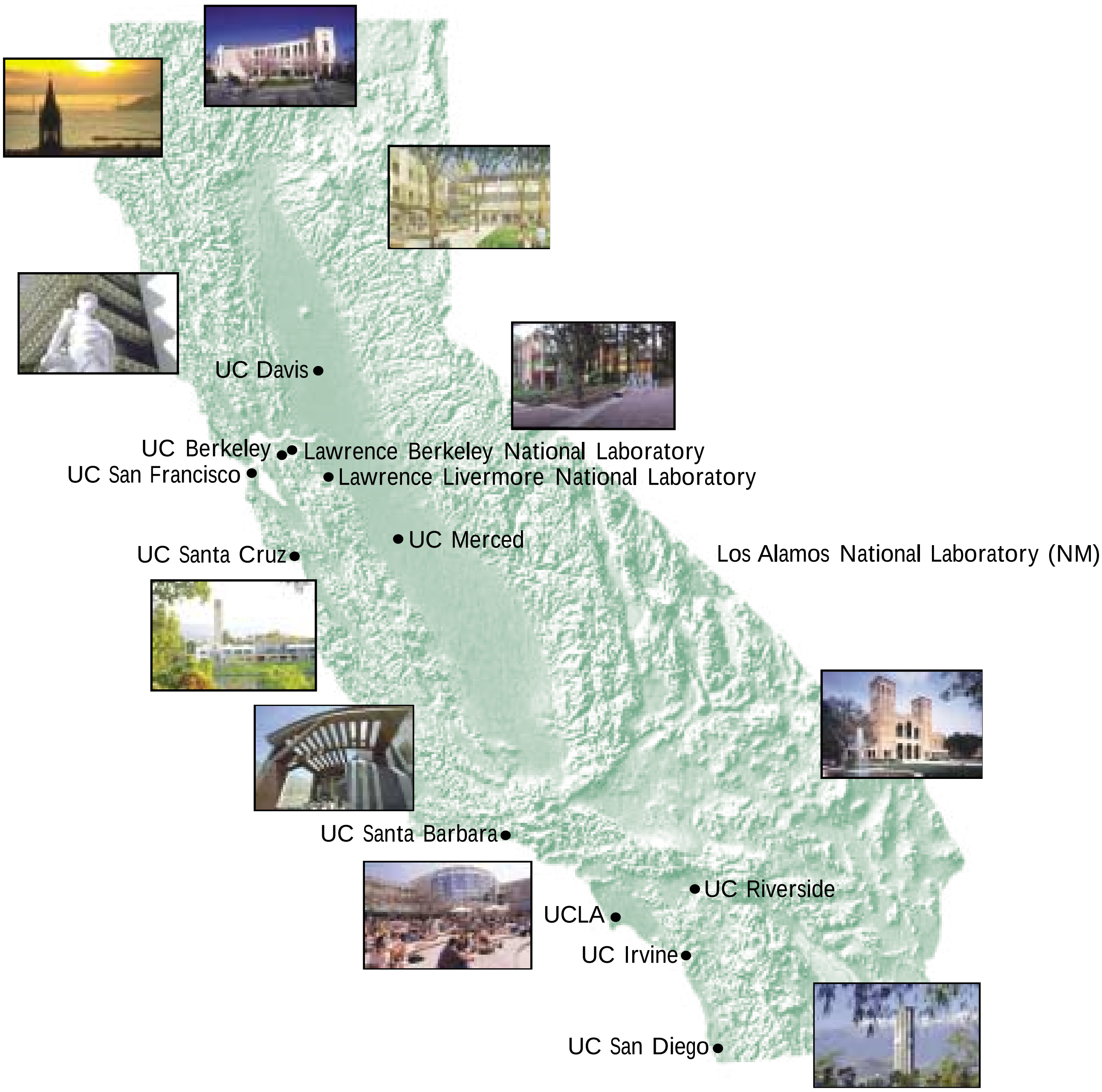
# Mission Statement

The Office of the Treasurer of The Regents manages the University of California's retirement, endowment and cash assets under the policies, guidelines, and performance benchmarks established by The Regents. The Office's mission is to implement those policies and guidelines by selecting, executing, and monitoring investment strategies designed to add value over the benchmarks within a risk controlled framework. The Office adheres to high ethical as well as professional standards in serving the financial management needs of its constituency.

# The University of California

The University of California, founded in 1868, is a system of 10 campuses with a mission of teaching, research and public service. With over 201,000 graduate and undergraduate students, UC is the world's premier public university. UC has three law schools, five medical schools and the nation's largest continuing education program. The University also manages three national laboratories that are engaged in energy and environmental research. Its Natural Reserve System manages approximately 130,000 acres of natural habitats for research, teaching and outreach activities.

Campuses and National Laboratories



# TREASURER'S ANNUAL REPORT FISCAL 2003-2004

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## FISCAL YEAR 2004 IN REVIEW

The global economy continued its recovery during the fiscal year, buoyed by an accommodative Federal Reserve and considerable fiscal stimulus in the U.S.; a turnaround in Japan; and very strong growth in China. Equity markets responded positively, with the Russell 3000 gaining 20.4% and the MSCI EAFE 32.8%. A revival of merger and acquisition activity boosted private equity markets, which produced gains similar to those of public equities.

As economic activity strengthened and headline Consumer Price inflation in the U.S. rose to 3.3% in June 2004 from 2.1% in June 2003, the Federal Reserve stated its intention to move to a more neutral stance. It raised short term interest rates in late June from a very low 1.00% to 1.25% and followed with two more 25 basis point increases after the close of the fiscal year. Ten-year U.S. Treasury yields rose to 4.5% from 3.5% at June 30, 2003, and the Lehman Aggregate Bond Index had a small positive return of 0.32% for the fiscal year.

The global economy appears on a solid footing, despite a slowdown in activity late in the fiscal year, and inflation has moderated from its earlier pace. Financial markets will be facing the following challenges in the coming months: employment gains have remained below expectations; oil prices have risen steadily to new highs of over $50 per barrel; global political tensions remain elevated; high healthcare costs and ongoing fallout from the past few years' corporate scandals have left some corporations in a cautious mode; and interest rates are rising at a modest pace.

## MESSAGE FROM THE TREASURER

All combined, the Board of Regents' assets grew by $5.6 billion or $5,602 million over the previous fiscal year, resulting in total assets of $59.1 billion and reflecting a total return of 12.42%. This return outperformed the total entity benchmark by 0.52%. We are pleased to report that the University of California Retirement Plan (UCRP), the General Endowment Pool (GEP), and the Short Term Investment Pool (STIP) all produced positive returns for the fiscal year; respectively UCRP +14.34%, GEP +14.65%, and STIP +3.35%. Each outperformed its policy benchmark. Our High Income Portfolio (HIP) returned -1.43%.

The UCRP grew by $3.9 billion over the fiscal year, net of all payments to beneficiaries and expenses. In fact, the UCRP paid out benefits of $1.1 billion to UC retirees for the year. As of January 1, 2004, the UCRP's estimated funded ratio was 120% on an actuarial basis. It is important to note that the UCRP's funding status is determined by a combination of two elements, both of which may fluctuate: 1) the value of the investment portfolio, and 2) the expected liability (payment obligation) stream. While the funded status of the UCRP has allowed for the temporary suspension of contributions, studies have shown an increased likelihood of required contributions within the next several years.

Our Office, working jointly with the University's Department of Human Resources and Benefits, enhanced the University's defined contribution plans in several ways this year. In a continuing effort to provide an appropriate selection of investment choices for our employees, we started the Balanced Growth Fund and TIPS (Treasury Inflation-Protected Securities) Fund in April 2004. These funds replaced the now- closed Money Market Fund and Multi-Asset Fund.

As of the writing of this Report, we mark the launch of the University's new 457(b) defined contribution plan. The Plan allows participants to contribute pretax dollars through salary deferral; contributions and any earnings remain tax deferred until they're withdrawn. This new 457(b) Plan may be of particular interest to employees who already participate in UC's Tax-Deferred 403(b) Plan. A recent change in federal law allows those participating in both plans to contribute up to twice as much as they could by participating in either plan alone.

The UC-managed defined contribution funds' combined market value at fiscal year end was $7.9 billion. Total returns (for those funds available for the full year) were as follows:

Equity Fund +21.70%, Bond Fund +0.10%, Savings Fund +4.11%, and Insurance Company Contract Fund +5.58%. The Balanced Growth Fund and TIPS Fund both outperformed their benchmarks for the quarter ended June 30th.

The markets continued to fluctuate, reminding investors that appropriate asset allocation planning be both appreciated and maintained. The Regents and our Office continually work toward improving returns without taking on excessive risk. We continue to diversify our holdings to provide for the long-term needs of the University, its programs and employees.

Investment philosophies and resulting policies vary due to a variety of factors including, but not limited to, payout needs, fiduciary oversight requirements, asset size and a myriad of convincing economic forecasts by highly-respected consultants. And, with changing market conditions, new investment instruments and continually rising liabilities, investment policies appropriate in the past need to evolve. For example, until recently the University's GEP and UCRP asset allocations were identical. Given their different payout goals and actuarial assessments our Office, in conjunction with The Regents, has gradually begun to fine tune the policies to better match each portfolio's long-term goals, reflecting the risk tolerance of the Board. Along with evolving investment policies, we have continued to fine tune the portfolios' *benchmark* policies, believing that performance is best measured against an appropriate benchmark.

Along these lines, this year's report includes updates on our recent allocations to Absolute Return and Real Estate strategies. We also offer an in-depth look at our approach to External Management.

I am extremely pleased to serve The Regents, faculty, staff and students of the University of California. Please visit our website for timely announcements and quarterly performance reporting at www.ucop.edu/treasurer/.

Best Regards,

David H. Russ
*Treasurer of The Regents and Vice President for Investments*
*University of California*
*October 2004*

## LOOKING FORWARD

In July 2004, upon completion of a Request for Proposal (RFP) process, The Regents selected Richards & Tierney, Inc. to serve as its Investment Program Consultant for a term of three years. During fiscal year 2004-2005, the Office of the Treasurer will work with Richards & Tierney to review existing asset allocations, benchmarks and investment policies. The Consultant will also work with the External Management Team to affirm managers selected through the RFP process.

As of the writing of this report, the Office is conducting an RFP for a Private Equity consultant which will work with the Alternative Investment Team. Selection should be completed in late 2004, and results will be presented to The Regents at a joint meeting of the Committee on Investments and Investment Advisory Committee. The Alternative Investments Team will also begin to implement the Real Estate investment strategy within UCRP and GEP during the upcoming fiscal year.

The Office will continue to collaborate with the University's Office of Human Resources and Benefits to review the investment options available within the University's defined contribution plans. The goal is to provide investment options that are easy to understand and communicate and offer an appropriate range of asset class choices. This review is part of a larger ongoing joint project which included creation of the new 457(b) Plan and the transfer of all defined contribution plan recordkeeping services to Fidelity Investments Tax-Exempt Services Company. Goals include expanded tax-deferred savings opportunities, a sustainable infrastructure and improved participant experience through a single master recordkeeping platform. A future phase of this project will include an RFP for an investment education provider and may explore the possibility of providing employees with individual portfolio management tools.

## INVESTMENT MANAGEMENT OVERVIEW

The investment funds managed by the Treasurer of The Regents consist of the University's retirement, defined contribution and endowment funds, as well as the system's cash assets. At June 30, 2004, the Treasurer's Office managed over $59 billion in total assets as outlined below.

TOTAL FUNDS UNDER MANAGEMENT[1]
June 30, 2004
($ in billions)

| | |
|---|---|
| University of California Retirement Plan (UCRP) | $39.3 |
| Defined Contribution Plan Funds | 7.9 |
| Endowment Funds | 5.3 |
| Short Term Investment Pool (STIP)[2] | 6.6 |
| Total Funds | $59.1 |

The Treasurer's Office investment management staff includes 22 investment professionals with an average of 17 years of investment experience.

### INVESTMENT OBJECTIVES & PHILOSOPHY

The investment objective for all funds under management is to maximize long-term total real returns while assuming appropriate levels of risk. Because the purpose of each fund is unique, The Regents has established the following specific objectives for each fund, along with the overall goal of exceeding the policy benchmark return and the rate of inflation:

Retirement Funds: for the University of California Retirement Plan, produce a real return to meet obligations to beneficiaries and to meet or exceed the actuarial rate of return; for the University-Managed Defined Contribution Funds, meet stated investment objectives for each fund.

Endowed Funds: to ensure that future funding for endowment-supported activities be maintained in perpetuity both by generating a growing payout stream and by growth of principal.

### ASSET ALLOCATION

Asset allocation is the primary determinant of long-term investment returns. UC funds are diversified among global equities and fixed-income securities, within a Regental target allocation (see pages 14, 27 and 30.) Historically, portfolio asset allocation has favored equity investments over fixed-income securities due to the expectation that equities will provide higher total returns over the long term. This emphasis on equity investing has resulted in substantial growth in both the endowment and retirement funds managed on behalf of The Regents.

The Portfolio Management Committee meets weekly to review asset allocation and other portfolio issues. Asset allocation rebalancing is required when an asset class moves out of the allowable range. The Treasurer decides on the timing and extent of the rebalancing, within The Regents' policy, based on market conditions.

### PUBLIC EQUITY INVESTING

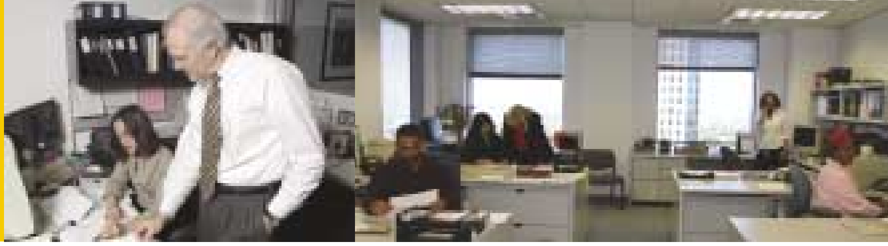
Historically, The Regents' Public Equity investment strategy utilized both active and passive management. In the process of implementing the November 2002 Regents-approved changes to the U.S. equity strategy, the internally managed U.S. common stock was transferred into a Russell 3000 Tobacco Free Index fund. As of fiscal year end, the Treasurer's Office has in place an internal team of experienced investment professionals selecting multiple U.S. equity strategies; selecting the external managers to implement these strategies; and monitoring those external managers on an ongoing basis. As strategies are implemented, the Office is transferring some of the holdings out of the index fund. As of the writing of this report, selection of Small Capitalization U.S. Equity and Large Capitalization U.S. Equity managers has been completed. The management team intends to implement a similar process for Non-U.S. Developed Market Equity, to be concluded in early 2005.

### FIXED INCOME INVESTING

Within the primary goal of maximizing total return over a long-term horizon, the members of the Treasurer's Office Fixed Income Team take an active approach to managing the portfolios, focusing on safety of principal, credit quality, liquidity and efficient use of risk. They start with a "top-down" approach to evaluate the global macroeconomic environment, including analysis of business cycles, monetary and fiscal policies, and political backdrops, in order to assign appropriate sector weights

[1] Market values include accrued income.

[2] The Short Term Investment Pool excludes the cash invested for, and reported as part of, the UCRP, Defined Contribution and Endowment Funds.



and duration exposure among the three core sectors of Government, Credit and Collateralized bonds. This is coupled with a "bottom-up" approach to individual security selection. Each portfolio manager utilizes a variety of proprietary and industry-developed analytical tools best suited for the particular sector, emphasizing rigorous analysis of such factors as yield curve exposures, portfolio duration and convexity, credit fundamentals, relative value and position weights.

The portfolio managers closely monitor current and prospective investments on a daily basis. New opportunities are identified, and existing positions are adjusted as appropriate. The team, along with representatives from the Risk Management Group, meet monthly to review performance, portfolio exposures and current economic assumptions. Potential new products and strategies are also presented at these sessions before seeking the Treasurer's approval. This combination of rigorous fundamental and quantitative analysis within an active risk management framework has produced a history of successful returns for The Regents' fixed income funds.

The Regents includes inflation-indexed bonds (TIPS) in its overall asset allocation to achieve the objective of maximizing long-term total real returns. The low correlation of TIPS returns with other asset classes also increases portfolio diversification. The Treasurer's Office inflation-indexed bond investment strategy utilizes passive management techniques. The objective of this strategy is to replicate the performance of the U.S. TIPS market.

The Treasurer's Office also manages the Short Term Investment Pool (STIP) for the benefit of numerous University groups. The STIP portfolio manager participates in the Fixed Income process with the Team as outlined above, but places a greater emphasis on generating current income in the execution of two major mandates.

The first is to insure that the daily liquidity needs of the University are met by investing an appropriate portion of total assets in short-term money market instruments at attractive yields relative to the desired quality. The second is to maximize the interest income paid to participants by investing the remaining funds not required for immediate expenditure in a variety of government and corporate bonds with maturities up to five years. The maturity restrictions and emphasis on quality assets help minimize the price volatility of the overall portfolio. The STIP has achieved an impressive long-term record of above-market interest income returns.

## PRIVATE EQUITY INVESTING

The Regents includes private equity investments such as venture capital and leveraged buyout partnerships in its overall asset allocation to increase portfolio diversification and reduce risk due to the low correlation of private equity with other asset classes. Adding to its attraction, return expectations for private equity are generally at least 300 basis points greater than those of the public equity markets.

Manager selection is key to this asset class, and the Treasurer's Office Alternative Investments Team has a strong competitive advantage and many years of successful experience. The University is seen as a sophisticated, long-term investor in the private equity arena, achieving above average returns over the past 25 years. The University has long standing relationships with many top-tier private equity groups and continues to build new relationships with premier firms. The objective is to build a well-diversified portfolio of top tier U.S. partnerships. The Team works with a private equity consultant to review private equity investment opportunities. The Team actively monitors investments through regular meetings with the general partners.

## ABSOLUTE RETURN INVESTING

The Absolute Return (AR) investments offer risk-return attributes that are not readily available through traditional equity and fixed income investments because they are designed to protect capital and provide positive returns irrespective of overall equity and fixed income market performance. The AR strategies are designed to achieve this by selling instruments short, in addition to positions owned long, to hedge out much of the market risk. AR investments typically have low correlation with other asset classes and increase the overall portfolio diversification and reduce risk. AR includes long/short equity, merger arbitrage, event-driven and other strategies. An AR portfolio might be net long, net short or neutral relative to the underlying investment market. AR strategies are currently used in the GEP only.

Strategy and manager selection are the important drivers of the Absolute Return allocation. The Treasurer's Office is focusing on a subset of available strategies to achieve diversification benefits and preservation of capital. The Office has also been able to invest with established and accomplished managers, including some that are no longer open to new investors. As of this writing, the GEP's 5% policy allocation to AR strategies has been implemented. The Alternative Investments Team works with a consultant that specializes in AR strategies.

Another critical element of the AR program is ongoing monitoring of the investments. Investments typically offer quarterly liquidity, which permits rebalancing toward strategies with a favorable outlook or redeeming from managers that are no longer suitable investments. The Treasurer's Office has regular contact with the investment managers to review adherence to the expected investment style, personnel turnover, performance and other issues to ensure the appropriate investments and allocations for the program.

## REAL ESTATE INVESTING

In May 2003, The Regents approved a 5% allocation to real estate for UCRP and GEP, funded from existing equity and bond allocations. Adding real estate investments to these portfolios is expected to provide long-term risk-adjusted total returns between those of U.S. equities and bonds; diversification benefits given real estate's low correlation with other asset classes; protection against unanticipated inflation; and a high proportion of the total return derived from current income.

The real estate investment program will begin during fiscal year 2004-2005 and will utilize a combined public and private market strategy. The dual strategy seeks to reduce risk within the real estate allocation, offers opportunities for increased liquidity and broader diversification (across investments, time and geography) and will enable the Treasurer to actively tilt overall real estate exposure toward public or private investments depending on relative valuations.

The public strategy will employ the use of external managers who specialize in publicly-traded real estate securities, such as real estate investment trusts (REITs). The private strategy will be accomplished through investing in limited liability investment vehicles, such as limited partnerships sponsored by experienced real estate investment firms with demonstrated expertise and superior performance. The Real Estate Investment Team, along with a real estate consultant, will review and recommend managers of publicly-traded investments and sponsors of private investments and screen investment opportunities. Upon completion of due diligence and subsequent investment selection, the Team will negotiate investment agreements and monitor performance.

## RISK MANAGEMENT

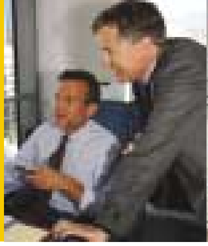
Investors perceive risk as the possibility of a loss which is accepted in order to achieve some investment goal. Thus investors accept risk to earn returns. In modern investment theory and practice, risk refers to this uncertainty of outcomes and is measured by the volatility of asset returns. Because risk is an essential aspect of investing, risk management is not about eliminating or necessarily reducing risk, but balancing risk and expected return. As Benjamin Graham said, "The essence of investment management is the management of risks, not the management of returns."

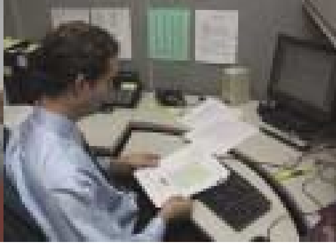
The primary objective of the Risk Management Team is to ensure that the Treasurer's Office investment and operational activities do not expose the University to potential or unexpected losses beyond The Regents' risk tolerance levels. This process involves three steps: 1) to identify risks and the range of possible losses; 2) to implement policies, guidelines and controls on the investment process to maintain the probability of loss within acceptable limits; and 3) to integrate risk monitoring, measurement, and analysis into all aspects of the investment process.

At the portfolio level, both quantitative and qualitative aspects of risk are monitored or measured to ensure that risk levels are proportionate to return expectations and that risk is taken intentionally and diversified optimally. At the plan level, risk management focuses on the adequacy of assets to pay promised benefits or to support spending policies. Other key components of the risk management process include scenario analysis, stress testing key assumptions, and optimization of risk and expected return. A key element of modern - and traditional - risk management is diversification across asset classes, strategies, and securities.

Risk exposures are continually monitored, compared to targets, and altered when appropriate. Pension plan risk factors include asset volatility, inflation and interest rates. Equity risk factors include economic activity, market risk preferences, style factors (e.g., relative value, capitalization size) and industry membership. Fixed Income risk factors include interest rate volatility, term structure, credit quality, mortgage prepayments, currency and liquidity. Private Equity and Real Estate risk factors include local economic activity, industry fundamentals and business risk. Absolute Return risk factors include the equity and fixed income factors defined above, and the degree to which they are offsetting, hedged or diversified.

Risk measurement is the first step in a process known as risk budgeting. Risk budgeting involves two additional steps: 1) determining the overall amount of risk required to meet a given investment objective and 2) budgeting or allocating it in an optimal manner. Optimal use of risk means constructing a fund so that, at the margin, the contribution to expected return of each sec-





tor, portfolio, or asset class is proportional to its estimated contribution to risk.  This process is being implemented in the Treasurer's Office over the next fiscal year and being integrated into the asset allocation and rebalancing process.

## OPERATIONS

Supporting the management of the portfolios is an experienced Operations staff consisting of a Director, Assistant Director, and Supervisor with an average of 16 years experience in banking and/or investment operations and seven analysts with an average of 11 years experience in investment accounting and operations. This unit is responsible for investment accounting and reporting, as well as the central management of all cash services for the University.

In addition to tracking and monitoring all investment security transactions and holdings, the Investment Operations staff verifies and analyzes the returns prepared by the Custodian Bank (State Street Corporation), prepares performance and holdings reports, and provides investment accounting entries for input into the UCOP Endowment and Investment Accounting general ledger. The Treasurer's Office has worked with State Street Corporation to plan and test a system to automatically post these investment accounting entries to the general ledger. The system was successfully implemented and put into production in July 2003.

The management of the portfolios is also supported by state-of-the-art information systems and a well-established custodial relationship with State Street Corporation, a leading industry provider, ensuring sound safekeeping and recording of assets. In addition, State Street Corporation has been the official book of record for the investment portfolios since June 2002. Among other functions, State Street provides independent calculations of the monthly performance data that is reported for the various portfolios.

## A WORD ABOUT BENCHMARKS

The primary objective of a performance report is to answer the question: what happened to our investments during the last quarter or year? But investors, fiduciaries, and other interested parties should immediately ask two more questions: what happened to our investments *relative to our investment goals* and objectives, and *how much risk was taken* to achieve those returns? Finding meaningful answers to these questions requires the selection of, and comparison of performance to, a diversified basket of similar securities of similar risk known as a *benchmark.*

While an investor may state that his or her long-term *goal* is to preserve purchasing power and increase assets by 5% in real terms, an investment *program* is best articulated in terms of an asset allocation. An asset allocation is the formal policy describing investments in terms of broad asset classes. A policy could be as simple as stating the percentage of assets to be invested in equities, fixed income, and cash equivalents, or it could be more detailed, e.g., further segmentation of equity into U.S. stocks, non-U.S. stocks, and private equity.

Once a policy allocation is set, the natural (and best) benchmark is the market index that most closely represents the asset class, such as the Russell 3000 Index for U.S. stocks or the Citigroup Large Pension Fund Index for U.S. bonds. Market indexes are also good benchmarks in that they represent the investor's "opportunity cost," i.e. an institutional investor can earn the index return via a low cost passively managed portfolio.

A policy benchmark for a *fund* can be a blend of indexes, each weighted by the percentage it represents in the asset allocation, e.g., 65% Russell 3000 + 35% Citigroup LPF. Additionally, although targets may be set for the percentages of assets in each category, it is customary to allow for a range around each target, to avoid frequent and costly rebalancing, and to allow for tactical deviations from policy when market conditions warrant (see range example on page 14).

When compared to its policy benchmark, a fund's investment performance reveals at least two things. First, whether the fund added value by allocating assets differently than the policy percentages. And second, whether the investments chosen within each asset class added value over their class benchmarks. This information is referred to as *performance attribution,* and it can be derived for each component of the total fund to understand further where and how value was added.

It is also natural to ask, how did the fund perform relative to those funds of peer institutions? The answer is not so straightforward, mainly because other institutions may utilize asset allocations that differ from their peers' and thus are expected to perform differently. This is especially true in the case of endowments and foundations. Before comparing performance, compare the asset allocation policies and designated benchmarks.

## SENIOR MANAGEMENT

DAVID H. RUSS, MA
Treasurer and Vice President for Investments

Mr. Russ is responsible for overseeing the University of California investment portfolio. Mr. Russ brings over 19 years of investment management experience to the Treasurer's Office. Prior to joining the Treasurer's Office in 2001, Mr. Russ served as Managing Director-Public Markets for the University of Texas Investment Management Company. Mr. Russ also served as the Director of Investment Management and Portfolio Manager for Pacific Telesis Group (now SBC Communications) and as Senior Portfolio Manager for the Stanford Management Company. Mr. Russ received his Master of Administration in Finance and Accounting from the University of California, Davis, and his BA degree in Genetics from the University of California, Berkeley.

MELVIN L. STANTON, MBA
The Assistant Treasurer

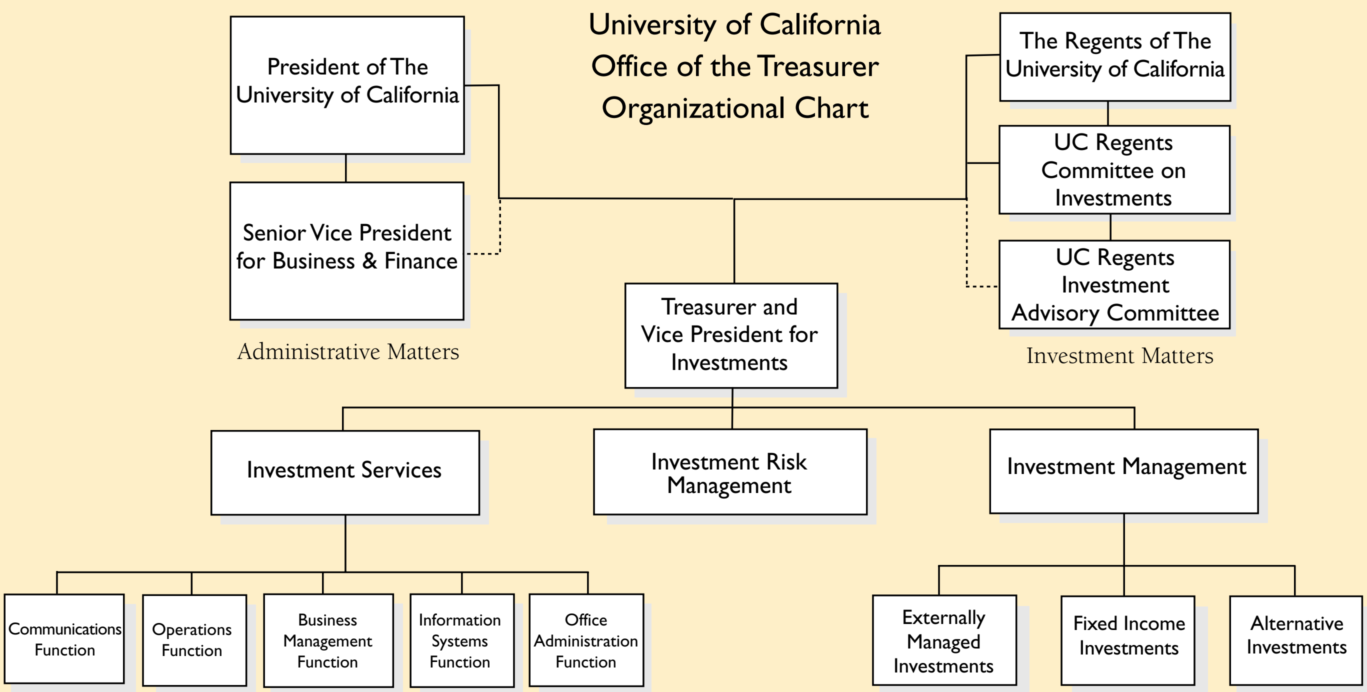
Mr. Stanton, along with the Treasurer, is responsible for the overall management of the Treasurer's Office. Prior to joining the Treasurer's Office in 1989, Mr. Stanton had more than 13 years experience as a financial executive in portfolio management and securities trading, including Director of Sales for Midland Montagu Securities, Inc., San Francisco; First Vice President and Manager with Crocker National Bank, San Francisco; and Vice President and Regional Sales Manager with Bankers Trust Company, Los Angeles. Mr. Stanton received his MBA and BS degrees from California State University, Northridge.

RANDOLPH E. WEDDING, MBA
Managing Director – Fixed Income Investments

Mr. Wedding is responsible for the strategic focus and management of the long- and short-term fixed-income portfolios. Prior to joining the Treasurer's Office in 1998, Mr. Wedding was Manager of Currency Options and Derivatives Trading for Bank of America, NT&SA, New York; Managing Director, Commodities and Derivative Sales for Bear Stearns & Co., New York; and Principal, Manager of Fixed-Income Derivative Sales for Morgan Stanley & Co., New York. Mr. Wedding began his career with Wells Fargo Bank, responsible for the Bank's Fixed Income Portfolio. Mr. Wedding earned his MBA in Finance from the University of California, Berkeley and BA in Mathematics from the University of California, San Diego.

MARIE N. BERGGREN, MS
Managing Director – Alternative Investments

Ms. Berggren is responsible for the private equity, real estate, and absolute return portfolios. Prior to joining the Treasurer's Office in 2002, Ms. Berggren was Executive Vice President/Department Head of Venture Capital Investments for Bank One Corporation. While employed at Bank One and its predecessor organization, First Chicago Corporation, she was the Senior Vice President and Department Head of the Corporation's Mergers and Acquisitions activity. Prior to that she was the Managing Director of Public Equities and Director of Research for First Chicago Investment Advisors (the predecessor to Brinson Partners). Ms. Berggren earned her MS in Management from Stanford University Graduate School of Business and a BA in Economics from the College of New Rochelle.




JESSE L. PHILLIPS, CFA, MBA, MA
Managing Director – Investment Risk Management

Mr. Phillips is responsible for integrating risk monitoring, measurement, and management into all aspects of the investment process. Prior to joining the Treasurer's Office in 2002, Mr. Phillips worked at Northrop Gruman for 11 years, first as Corporate M&A Analyst and then as Manager, Risk Analysis and Research in the Treasury department. Mr. Phillips also worked as Corporate Planning Analyst with Florida Power & Light Company and as Senior Financial Analyst with Storer Communications, Inc., both in Miami Florida. Mr. Phillips earned his BA degree in Mathematics/Economics and MA in Applied Mathematics from the University of California, Los Angeles and his MBA in Finance from the University of Miami. Mr. Phillips is a CPA (Florida) and holds the CFA designation.

ROBERT B. BLAGDEN, MBA
Managing Director – Externally Managed Investments

Mr. Blagden is responsible for overseeing all externally managed funds and activities with overall responsibility for executing an investment strategy that generates optimal total return relative to risk taken. Prior to joining the Treasurer's Office in 2003, Mr. Blagden had more than 35 years experience as a financial executive, including most recently serving as Director of Investments overseeing endowment assets of the Ludwig Institute for Cancer Research. Previous to this position, Mr. Blagden served as Managing Director, Public Equity for the Stanford Management Company, when the company was established in 1991. He served as Associate Treasurer in the Treasurer's Office of Stanford University from 1982-1991. Prior corporate planning and finance positions held at Kaiser Cement Corporation between 1968 and 1982 included management of pension and profit sharing assets. Mr. Blagden received his MBA, Finance degree from Stanford University Graduate School of Business and his BA in Statistical Psychology from Dartmouth College.

# *Investing In Depth*

Insight into the Office of the Treasurer's approach to selecting and monitoring external managers.

## BACKGROUND

In November 2002, The Regents approved two core changes to the public equity strategy: move from internal management to multiple external managers and diversify from a single concentrated actively-managed large capitalization strategy to a range of diversified equity strategies. The Regents approved the enhancements in order to improve equity investment performance, reduce overall portfolio risk exposures, and to conform the University's practices to the national industry norm of institutional external equity management. This move was both an extension of, and consistent with, the University's overall asset allocation investments strategy approved by The Regents in March 2000.

## INITIAL STEPS

This diversification affected the U.S. and Non-U.S. Equity allocations within the General Endowment Pool (GEP) and the University of California Retirement Plan (UCRP). To initiate the transition to external equity management, the University transferred all of its internally managed U.S. Equity investments into a Russell 3000 Tobacco-Free (TF) Index Fund managed by State Street Global Advisors, a leading institutional investment manager and UC's current passive index manager. This resulted in the closure of the Office of the Treasurer's internal equity portfolio management division. The transfer of $15 billion, from a concentrated portfolio of 156 stocks to a broadly diversified index fund, was completed in November 2002 and the transition resulted in a net gain of $619 million.

Next, the Treasurer's Office created the Externally Managed Investments Team (the "Team") whose role is to determine the optimal range of equity strategies and implement a Request For Proposal (RFP) process to hire qualified active external managers within each of these strategies. Team members possess a total of 61 years of industry experience selecting and monitoring managers, acquired working within both consultant and plan sponsor environments.

> "Our Team has had the ideal, yet challenging, opportunity to build this program from the ground up. We share the Treasurer's long-term focus and possess the knowledge and skills needed to meet the University's goals."
>
> Robert Blagden, Managing Director

As external managers are hired, holdings are transferred out of the U.S. and Non-U.S. index funds. The objective is to retain investment managers who are expected to add value by outperforming their respective benchmark indices net of all management fees on a risk adjusted basis. The Team monitors the managers on an ongoing basis.

## CURRENT PUBLIC EQUITY ASSET ALLOCATION GUIDELINES: ACTIVE VS. INDEXED

Currently, 75% of the U.S. Equity assets in UCRP and GEP will remain indexed to the Russell 3000 TF. The remaining 25% of U.S. Equity assets will be placed with active managers representing a range of small capitalization and large capitalization strategies, utilizing core, value and growth styles. The active component of the U.S Equity allocation seeks to outperform the Russell 3000 TF index.

It is anticipated that passively managed Non-U.S. Developed Markets Equity assets in UCRP and GEP will remain indexed to the MSCI EAFE + Canada TF Index while a portion of Non-U.S. Developed Markets Equity assets will be placed with active managers representing a range of different capitalization and style approaches. These approaches, in aggregate, will be expected to outperform the MSCI EAFE + Canada TF index. Non-U.S. Emerging Markets Equity assets in UCRP and GEP will be managed in active or passive strategies designed to outperform the MSCI EMF Index. Total Non-U.S. Equity assets will be managed in a combination of indexed and active strategies designed, in aggregate, to outperform the MSCI All Country World ex U.S. Index.

Externally-Managed Investments Team

*Seated, from left to right:* David Russ, Treasurer; Kristina Chow, Administrative Assistant. *Standing, from left to right:* Burton Yuen, Investment Officer; Steven Algert, Investment Officer; Robert Blagden, Managing Director.

## THE EXTERNAL MANAGER SELECTION PROCESS

The selection process within all three segments of Public Equity (small capitalization U.S. equity, large capitalization U.S. equity and non-U.S. developed market equity) is similar. The RFPs are posted online and advertised in a trade journal. Once completed, RFPs are received by the Treasurer's Externally Managed Investments Team, minimum requirements are verified and screening begins.

The Team focuses on experienced, proven managers and includes analysis of people, process, organization and performance. Given the Team's extensive industry experience in selecting and monitoring investment managers, they are able to stay focused on meaningful issues and remain flexible and efficient during the selection process.

A 'short list' of managers is compiled by the Team and reviewed with The Regents' investment consultant. Members of the Team conduct due diligence visits to the short list of managers and conduct risk/attribution analysis.

Finalists are selected by the Team and The Regents' consultant affirms a list of acceptable managers. Fee and contract negotiations are completed by the Team with a subset of the affirmed managers, and the resulting agreements have either performance- or asset-based fees. Finally, assets are transitioned to the active managers from the indexed portfolio.

Details specific to the completed Small Capitalization U.S. Equity Manager selection process are available on line at http://www.universityofcalifornia.edu/regents/regmeet/aug04/603attach.pdf. The selected managers represent a balance of core, growth and value styles.

At the writing of this report the Large Capitalization U.S. Equity Managers are funded and the Non-U.S. Developed Market Equity Manager RFP is not yet completed. The Non-U.S. Developed Market Equity Manager RFP process should be concluded in early 2005. The Team provides updates to The Regents' Committee on Investments and the Regents' Investment Advisory Committee on a regular basis. Regents' meeting and agenda information is available at http://www.universityofcalifornia.edu/regents/meetings.html.

## LOOKING AHEAD

As stated earlier, the Team monitors the managers on an ongoing basis. Should a manager be identified as needing to be removed or replaced, the Team will take appropriate actions. The Treasurer's Office works with The Regents and its Consultant to continue to ensure that appropriate asset allocations and diversification are maintained.

# General Endowment Pool (GEP)

**GENERAL ENDOWMENT POOL (GEP)**
Summary of Investments[1]
($ in thousands)

| | June 30, 2004 | | June 30, 2003 | |
|---|---|---|---|---|
| GENERAL ENDOWMENT POOL | Market Value | % of Pool | Market Value | % of Pool |
| EQUITIES | | | | |
| U.S. Equity | $ 2,609,207 | 54.6% | $ 2,461,351 | 56.2% |
| Non-U.S. Equity | 530,978 | 11.1% | 316,436 | 7.2% |
| Private Equity | 103,013 | 2.2% | 114,705 | 2.6% |
| TOTAL EQUITIES | $ 3,243,198 | 67.9% | $ 2,892,492 | 66.0% |
| FIXED-INCOME SECURITIES | $ 1,273,472 | 26.6% | $ 1,382,661 | 31.5% |
| ABSOLUTE RETURN | $ 250,253 | 5.2% | $ 106,288 | 2.4% |
| LIQUIDITY PORTFOLIO | $ 15,350 | 0.3% | $ 3,740 | 0.1% |
| TOTAL GENERAL ENDOWMENT POOL | $ 4,782,273 | 100.0% | $ 4,385,181 | 100.0% |
| OTHER ENDOWMENT FUNDS | $ 375,587 | | $ 304,461 | |
| TOTAL GEP AND OTHER ENDOWMENT FUNDS | $ 5,157,860 | | $ 4,689,642 | |

Established in 1933, and unitized in 1958, the General Endowment Pool (GEP) is The Regents' primary investment vehicle for endowed gift funds. GEP is comprised of over 4,350 individual endowments that support the University's mission. GEP is a balanced portfolio of equities and fixed-income securities in which all endowment funds participate, unless payout needs require otherwise.

The June 30, 2004 market value of GEP was $4.8 billion, or $17.76 per share, versus $4.4 billion, or $15.90 per share, at the end of fiscal 2003. Total GEP net investment income for the year was $121.8 million, or $0.44 per share, versus $123.8 million, or $0.46 per share, for fiscal 2003.

## SPENDING POLICY

The Regents adopted a total return investment philosophy aimed at achieving real asset growth in order to generate growing annual payouts to support donors' designated programs. In October 1998, The Regents adopted a long-term spending rate range of 4.35% to 4.75% of a 60-month (5-year) moving average of GEP's market value. The Regents reviews the payout rate each year in the context of GEP's investment returns, inflation and the University's programmatic needs, in conjunction with prudent preservation of principal and prudent increases in the payout amount. In November 2002, The Regents adopted a rate of 4.5% for expenditure in the 2003-2004 fiscal year.

## INVESTMENT OBJECTIVE

The overall investment objective for all GEP assets is to maximize real, long-term total returns (income plus capital appreciation adjusted for inflation), while assuming appropriate levels of risk.

The primary goal for GEP is to ensure that future funding for endowment-supported activities be maintained both by generating a growing payout stream and by growth of principal.

## INVESTMENT STRATEGY

In order to continue to achieve these investment objectives, The Regents adopted the following asset allocation policy in May 2003:

| Asset Class | Policy | Minimum | Maximum |
|---|---|---|---|
| U.S. Equity | 42% | 37% | 50% |
| Non-U.S. Equity | 10% | 8% | 12% |
| Private Equity | 10% | 5% | 12% |
| Fixed Income | 28% | 23% | 35% |
| Absolute Return | 5% | 0% | 6% |
| Real Estate | 5% | 0% | 7% |

The asset allocation benchmarks and portfolio guidelines are designed to manage risk and ensure portfolio diversification. The benchmarks for the individual asset classes are: Russell 3000 Tobacco Free (TF) Index for U.S. Equity; Morgan Stanley Capital International All Country

[1] For fiscal 2002 and fiscal 2003, the cash portion of the various portfolios excludes the unrealized market appreciation or depreciation of STIP investments, accounts receivable and accounts payable, and the investments in the security lending collateral pool. Therefore, the balances differ from the University's Annual Financial Report.

World Index ex-U.S. for Non-U.S. Equity; Russell 3000 TF Index +3% (lagged 3 months) for Private Equity; Citigroup Large Pension Fund (LPF) Index for Fixed Income; 91-Day Treasury Bill + 4.5% for Absolute Return; and NCREIF Property Index for Private Real Estate and the Wilshire REIT Index for Public Real Estate. The total fund benchmark is a policy-weighted average of the individual asset class benchmarks.

In November 2002, The Regents approved two core changes to the U.S. equity strategy: move from internal management to multiple external managers and diversify from a single actively managed large capitalization strategy to a range of equity strategies. The internally managed U.S. common stock was transferred into a Russell 3000 Tobacco Free Index fund managed by State Street Global Advisors, which is intended to mirror the returns of the broad U.S. stock market. During 2003-2004, UC began to hire active external managers, beginning with Small Capitalization and Large Capitalization strategies, and transferred some of these holdings out of the index fund.

In the Non-U.S. Equity category, 85% is invested in a MSCI EAFE + Canada Tobacco Free Index fund managed by State Street Global Advisors, designed to mirror the returns of the broad developed foreign stock markets. The remaining 15% is invested in emerging markets commingled institutional funds, to gain exposure to the developing foreign markets.

For Private Equity, the Treasurer's Office seeks opportunities through recognized top-tier venture capital partnerships and select buyout funds.

For Fixed-Income investments, the Treasurer's Office analyzes relative value among the core benchmark sectors of Governments, Corporates, and Mortgage-backed securities and overweights those sectors and securities offering attractive real returns, while maintaining a risk level commensurate with the benchmark index.

For Absolute Return, investments include long/short equity, arbitrage, event-driven and other strategies.

For Real Estate, investments currently include residual gifts only. The Real Estate program will begin implementation in fiscal year 2004-2005.

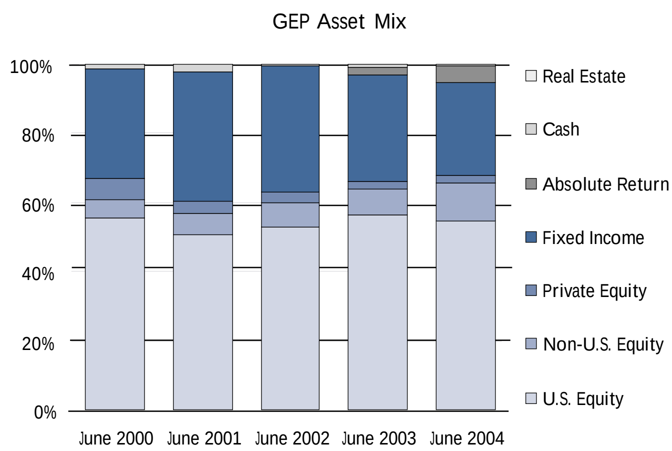
## RETURNS

Throughout the years, GEP has exceeded its fund objectives. As illustrated in the table on page 17, GEP has consistently performed well vs. its policy benchmarks. GEP's total return of 14.65% for the fiscal year primarily reflects the strong performance of equities, buoyed by a rebounding global economy, along with flat bond market returns, as yields rose modestly. For the past 10 years, GEP's compound annual total return was a strong 12.04% vs. 11.40% for its benchmark. During that time, payout distributions grew at an average annual rate of 9.2%—well above annualized inflation of 2.5%.

The cumulative Total Returns Chart on page 16 illustrates the returns for GEP for the past 10 years relative to the policy benchmark and inflation.

## ASSET MIX

The following represents GEP's asset mix as of each of the past five fiscal year ends.




## EQUITY INVESTMENTS

The equity portion of GEP consists primarily of U.S. and Non-U.S. common stocks, with a modest exposure to private equity. Total equities represented 67.9% of GEP at year-end, with a market value of $3.2 billion.

U.S. Equity represented 54.6% of the fund at year-end, with a market value of $2.6 billion. GEP's U.S. Equity assets were indexed for the fiscal year and returned a strong 20.48%. GEP's U.S. Equity return of 10.99% for the 10-year period underperformed the benchmark return of 12.19%.

Non-U.S. Equity represented 11.1% of GEP at year-end, with a market value of $531 million. GEP's Non-U.S. Equities gained 31.58% in the fiscal year, similar to the benchmark return gain of 32.03%. The 5- and 10-year returns for this asset class represent the emerging markets funds only, so comparisons are not yet meaningful.

## ALTERNATIVE INVESTMENTS

Private Equity represented 2.2% of GEP at year-end with a market value of $103 million. GEP returns for this asset class in the fiscal year were 19.01%, underperforming the benchmark return of 41.90%. Over the past 5 and 10 years, however, GEP's private equity returns of 15.51% and 26.03% have been an important contributor to total fund return. Longer-term, this category should provide attractive returns, although likely more modest than those of the previous decade.

Absolute Return represented 5.2% of GEP at year-end and returned 8.82% in the fiscal year, above the benchmark return of 5.44%.

As discussed earlier, the Real Estate program will be implemented in fiscal year 2004-2005. Assets shown in last year's report represented a single gift which was sold as of June 30, 2004.

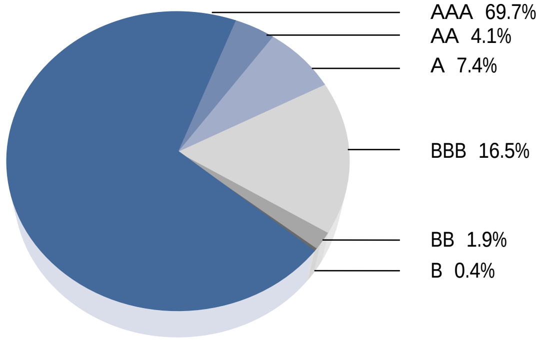
## FIXED-INCOME INVESTMENTS

At year-end, Fixed Income constituted 26.6% of the portfolio, with a market value of $1.3 billion.

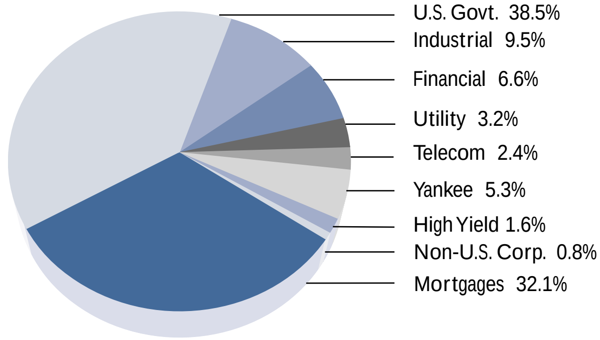
GEP's fixed-income investments returned (0.67)% during the year, outperforming the benchmark return of (0.79)%. GEP's fixed income return of 10.23% for the 10-year period exceeded the benchmark returns of 8.71%.

The weighted average maturity of the bond portfolio at year-end was approximately 12 years, the average duration 7.0 years, and the average credit quality was AA, with more than 81% of fixed-income securities rated A or higher. The following pie charts illustrate the sector mix and quality breakdown of the GEP bond portfolio.

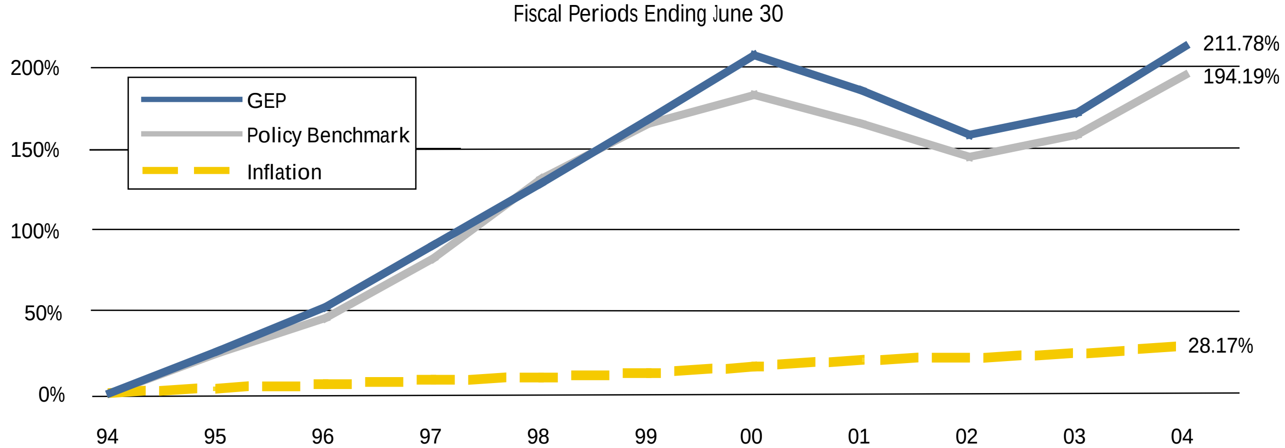
GEP Fixed Income Quality Mix
June 30, 2004
(BBB and higher = investment grade) Average Quality = AA

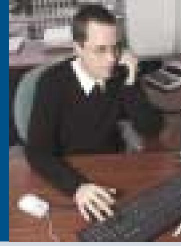



GEP Fixed Income Sector Mix
June 30, 2004




GEP Cumulative Total Returns: Fiscal 1995-2004
Fiscal Periods Ending June 30





## GEP ANNUALIZED TOTAL RETURNS[1] VERSUS BENCHMARKS AND INFLATION

June 30, 2004

| | 1-Year | 5-Year | 10-Year | 10-Year Cumulative | Benchmark Description[2] |
|---|---|---|---|---|---|
| **TOTAL FUND** | | | | | |
| GEP | 14.65% | 3.14% | 12.04% | 211.78% | Total Fund Policy Benchmark: A blend of the indexes described in detail below, each weighted by the percentage it represents in the asset allocation. Adjustments have been made to reflect that the actual investment in Private Equity and Real Estate are below policy weights. Annual index returns assume monthly rebalancing. |
| Policy Benchmark | 14.59 | 2.17 | 11.40 | 194.19 | |
| Inflation | 3.27 | 2.68 | 2.51 | 28.17 | Inflation: Consumer Price Index. |
| **U.S. EQUITY** | | | | | |
| GEP | 20.48% | (2.16)% | 10.99% | 184.32% | U.S. Equity Policy Benchmark: Russell 3000 TF Index; Historical: S&P 500 Index. |
| Policy Benchmark | 20.48 | (1.58) | 12.19 | 215.81 | |
| **NON-U.S. EQUITY** | | | | | |
| GEP | 31.58% | (2.70)% | 1.09% | 11.44% | Non-U.S. Policy Benchmark: MSCI AC World ex US Index; Historical: MSCI EMF Index. |
| Policy Benchmark | 32.03 | (0.63) | (0.73) | (7.04) | |
| **PRIVATE EQUITY** | | | | | |
| GEP | 19.01% | 15.51% | 26.03% | 910.98% | Private Equity Policy Benchmark: Russell 3000 TF Index + 3% (lagged by 3 months); Historical: S&P 500 Index +5%. |
| Policy Benchmark | 41.90 | (1.32) | 15.10 | 308.34 | |
| **FIXED INCOME** | | | | | |
| GEP | (0.67)% | 7.74% | 10.23% | 164.88% | Fixed Income Policy Benchmark: Citigroup Large Pension Fund Index. Historical: LB LT G/C Index. |
| Policy Benchmark | (0.79) | 7.75 | 8.71 | 130.51 | |
| **ABSOLUTE RETURN** | | | | | |
| GEP | 8.82% | N/A | N/A | N/A | |
| Policy Benchmark | 5.44 | N/A | N/A | N/A | Absolute Return Policy Benchmark: 91-Day TBills + 4.5%. |
| **REAL ESTATE** | | | | | |
| GEP | 81.42% | N/A | N/A | N/A | Real Estate Policy Benchmark: NCREIF Property Index for private real estate and the Wilshire REIT Index for public real estate. |
| Policy Benchmark | 9.71 | N/A | N/A | N/A | |

[1] GEP's total returns are based on unit values calculated by UCOP Endowment and Investment Accounting and are net of (after) investment management and administrative expenses of 0.09% of average annual market value, which are automatically deducted from income. The asset class returns reflect investment returns. The performance of The Regents' total return investment portfolio is calculated by State Street Bank, according to the standard recommended by the Bank Administration Institute (BAI), which uses a time-weighted methodology that essentially neutralizes the effect of contributions and withdrawals so as to measure only the return on assets. These calculations comply with the CFA Institute's standards, which require time-weighted rates of return using realized and unrealized gains plus income. Performance calculations are reconciled by the Treasurer's Office.

[2] Historical benchmark allocation information is available online at http://www.ucop.edu/treasurer/invret/Benchmarks.html.



## ASSET DESIGNATION BY CAMPUS AND PURPOSE

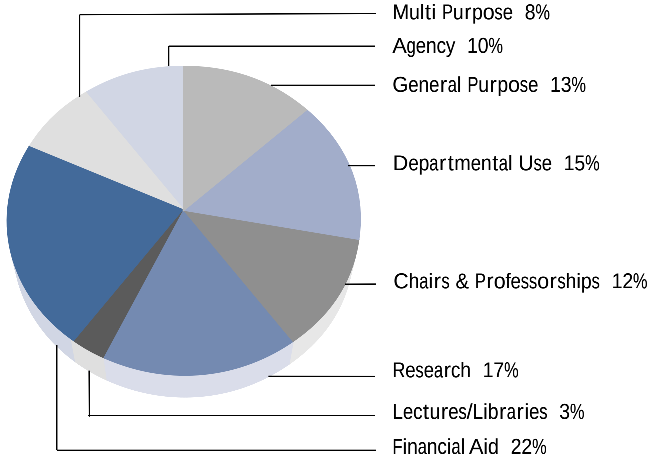
A donor has two avenues for making a gift to or establishing an endowment at the University: directly to The Regents for a specific campus and/or purpose or directly to a campus through its Foundation. The campus foundation trustees have discretion in their choice of investment managers and may use the Treasurer's Office or external investment managers.

The Regents' endowment pools include assets that were gifted directly to The Regents, as well as foundation assets where the Treasurer was retained as the investment manager. The chart below illustrates the breakdown of GEP's assets among the campuses. Not surprisingly, a higher proportion of the assets is dedicated to the older campuses, which have a more established alumni and donor base.

Fundraising efforts provide critically needed monies to support the goals of the University. As illustrated by the chart at the right, more than half of GEP's assets support departmental use (15%), financial aid (22%) and research (17%).

More detailed information on fundraising results may be found in the University's *Annual Report on Private Support* published by the Office of University and External Relations.

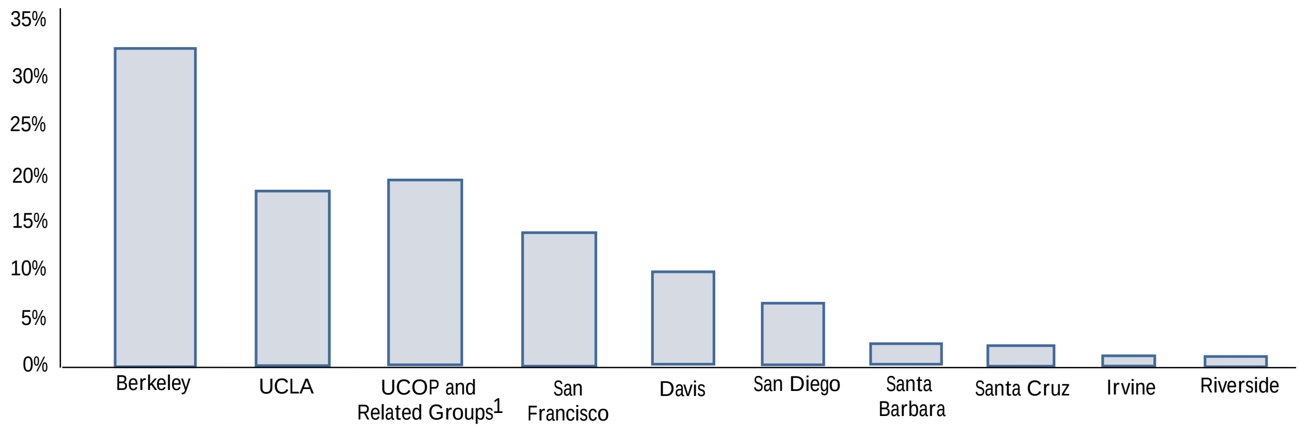
GEP Assets Designated by Purpose
June 30, 2004




## OTHER ENDOWMENT FUNDS

At June 30, 2004, The Regents had $268 million invested in separately managed endowment funds (including approximately $191 million where The Regents is the beneficiary, but not the trustee). The separately managed funds were established to achieve specified payout requirements for donor and agency monies, as well as to comply with the terms of gift agreements in which donors required funds to be invested separately (e.g., no commingling of funds) and/or placed restrictions on the investment options (e.g., only U.S. Treasury bonds).

GEP Assets Designated by Campus
June 30, 2004




[1] UCOP = UCOP-administered programs and multi-campus gifts.

## DR. JULES STEIN

Dr. Jules Stein, born in 1896 in South Bend, Indiana, made his mark in the world as an ophthalmologist, musician, businessman, and philanthropist. He financed his education – a Ph.B. (Bachelor of Philosophy degree) from the University of Chicago and an M.D. from Rush Medical College and postgraduate studies at the University of Vienna and Chicago's Cook County Hospital – by playing in a band. In 1924, Dr. Stein's musical and business prowess steered him from medicine into entertainment, leading to his founding of America's most renowned talent agency, Music Corporation of America (MCA). Ultimately, he turned this early enterprise into the entertainment empire known as Universal Studios. Dr. Stein's unique talents as a businessman and ophthalmologist, along with his accumulated wealth and network of associates, firmly fixed his place in history as a renowned philanthropist in the vision sciences.

In 1959, after a visit to the New York Lighthouse for the Blind, Doris Stein, his wife and a philanthropic pioneer in vision science in her own right, strongly urged Dr. Stein to "do something!" With great enthusiasm, he redirected his focus from entertainment to ophthalmology.

In 1960, Dr. Stein with Robert E. McCormick, founded one of three major national institutions committed to vision science, Research to Prevent Blindness (RPB). Over the next decade, Dr. Stein worked to raise consciousness and awareness of the need for research in the vision sciences in both the public sector and government. Eight years after founding RBP, Dr. Stein successfully campaigned to establish the second national institution, National Eye Institute (NEI) – an independent entity in the National Institutes of Health in Bethesda, Maryland. As with RPB, he helped make NEI a recognizable force in supplying resources to researchers in the field of vision.

RPB and NEI were no small achievements; however, the accomplishment most satisfying for Jules Stein in his and Doris's campaign for advancement in the field of vision came in the founding of the Jules Stein Eye Institute (JSEI) on the UCLA campus in 1966.

Ascribed as the world's foremost supporter in the preservation of vision and prevention of blindness, Dr. Stein forever transformed the world of vision science and the University of California with his forward-thinking conception of an eye institute worthy of his name and UCLA's reputation. At the request of Dr. Bradley Straatsma, Chairman of UCLA's Division of Ophthalmology, Dr. Stein led the efforts to engineer plans for a world-renowned eye institute within UCLA's medical school, dedicated to preserving vision and preventing blindness through research, education, patient care, and community outreach.

With the support of the University, RPB, and the Jules Stein family and friends in the entertainment and business worlds, Dr. Stein raised more than $12 million needed to complete the project. The University contributed the details for the structure and its content, and Dr. Straatsma and the UCLA ophthalmology faculty provided the professional and technical features, but it was Dr. and Mrs. Stein's stylistic and design influence that brought JSEI to life.

Dr. Stein died in 1981, leaving a legacy of achievement, optimism, and perseverance in the evolution of the vision sciences. Among all his accomplishments, the fruition of his concept for JSEI will ensure that the finest research and development, training, and patient care in the field of vision science lives on.

Dr. Jules Stein
1896 - 1981

Degrees: M.D. in Ophthalmology and Ph.B. (Bachelor of Philosophy)

Jules Stein on the Eye Institute:
"It's really the greatest thing I've ever done. I think I'll be better remembered for the treatment of diseases of the eye and prevention of blindness than for the founding and building of MCA."

We wish to acknowledge the help of The Jules Stein Eye Institute Development Office at UCLA. For more information on The Jules Stein Eye Institute visit their website at http://www.jsei.org.

# High Income Pool (HIP)

HIGH INCOME POOL (HIP)
Summary of Investments[1]
($ in thousands)

| | June 30, 2004 | | June 30, 2003 | |
|---|---|---|---|---|
| | Market Value | % of Pool | Market Value | % of Pool |
| HIGH INCOME ENDOWMENT POOL | | | | |
| Equities | $3,051 | 4.8% | $7,928 | 8.6% |
| Fixed-Income Securities | $59,945 | 93.8% | $82,280 | 89.6% |
| Liquidity Portfolio | $869 | 1.4% | $1,647 | 1.8% |
| TOTAL HIGH INCOME ENDOWMENT POOL | $63,865 | 100.0% | $91,855 | 100.0% |

[1] For fiscal 2003 and fiscal 2004 the cash portion of the various portfolios excludes the unrealized market appreciation or depreciation of STIP investments, accounts receivable and accounts payable and the investments in the security lending collateral pool. Therefore, the balances differ from the University's Annual Financial Report.

The High Income Pool (HIP) was established in May 1987 to accommodate endowments with high payout requirements and deferred gift giving programs with high contractual payout obligations. As such, HIP is a balanced portfolio comprised primarily of fixed-income securities, along with select higher-yielding equities. The General Endowment Pool (GEP) remains The Regents' primary investment vehicle for endowed gift funds.

The June 30, 2004 market value of HIP was $63.9 million, or $1.75 per share, versus $91.9 million, or $1.88 per share, at the end of fiscal 2003. HIP generated a total return of (1.43%) for the fiscal year.

Total HIP net investment income for the year was $4.3 million, or $0.103 per share, versus $5.0 million, or $0.104 per share, for fiscal 2003. HIP's current yield on market value at June 30, 2004 was 5.67%.

## SPENDING POLICY

Although The Regents adopted a total return spending policy for GEP in 1998, the income only payout spending policy is being maintained for HIP given the nature of the gifts and their required payouts.

## INVESTMENT OBJECTIVE

The overall investment objective for all HIP assets is to maximize real, long-term total returns (income plus capital appreciation adjusted for inflation), while assuming appropriate levels of risk.

For HIP, the primary goal is to produce a relatively high and stable level of current income sufficient to meet the needs of the specific funds, with moderate growth of income and preservation of capital.

## INVESTMENT STRATEGY

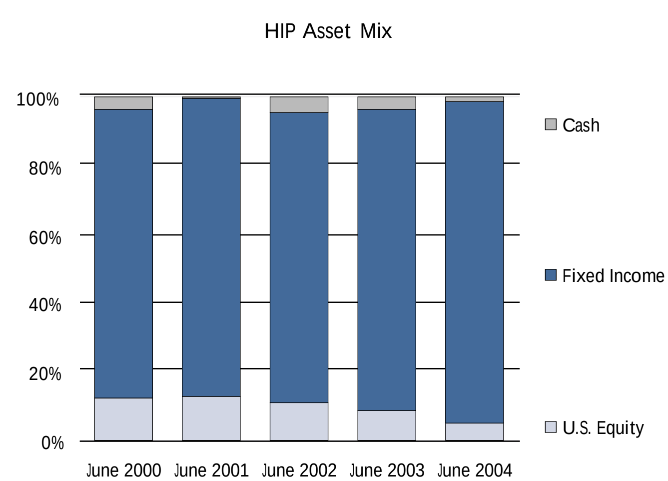
In order to achieve these higher income goals, The Regents' asset allocation strategy for HIP calls for the majority of assets to be invested in fixed-income securities. The Treasurer's Office targets those fixed-income securities and equities that will provide a high level of current income and can also generate moderate growth. The Treasurer's Office may vary the asset mix to maintain a relatively high level of income.

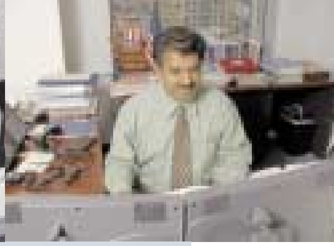
## RETURNS

During its 17-year history, HIP has performed very well versus its benchmark. HIP's return of (1.43%) in the fiscal year reflects its emphasis on fixed income investments, which posted negative returns as yields rose modestly.

## ASSET MIX

The following chart represents HIP's asset mix as of each of the past five fiscal year ends.





HIP ANNUALIZED PERFORMANCE VERSUS BENCHMARK AND INFLATION
June 30, 2004

| Annualized Total Returns | 1-Year | 5-Year | 10-Year | 10-Year Cumulative | Benchmark Description |
|---|---|---|---|---|---|
| TOTAL FUND | | | | | Total Fund Policy Benchmark: From 7/1/87 - 9/30/89, the benchmark consisted of 80% LB LT G/C; 20% S&P Utilities. From 10/1/89 - 6/30/04, the benchmark consisted of 80% LB LT G/C; 20% S&P 500 Electric Utilities. Inflation: Consumer Price Index. |
| HIP[1] | (1.43)% | 7.36% | 10.98% | 183.35% | |
| Policy Benchmark | 0.25 | 7.81 | 9.29 | 143.21 | |
| Inflation | 3.27 | 2.68 | 2.51 | 28.17 | |

| Annualized Income Returns | 1-Year | 5-Year | 10-Year | 10-Year Cumulative |
|---|---|---|---|---|
| TOTAL FUND | | | | |
| HIP | 5.71% | 6.26% | 6.35% | 85.09% |
| 5-Year U.S. Treasury Notes | 3.20 | 4.49 | 5.33 | 68.08 |

[1] HIP's total returns are based on unit values calculated by UCOP Endowment and Investment Accounting and are net of (after) investment management and administrative expenses of 0.09% of average annual market value, which are automatically deducted from income. The performance of The Regents' total return investment portfolio is calculated by State Street Bank, according to the standard recommended by the Bank Administration Institute (BAI), which uses a time-weighted methodology that essentially neutralizes the effect of contributions and withdrawals so as to measure only the returns on assets. These calculations comply with the CFA Institute's standards, which require time-weighted rates of return using realized and unrealized gains plus income. Performance calculations are reconciled by the Treasurer's Office.

## FIXED-INCOME INVESTMENTS

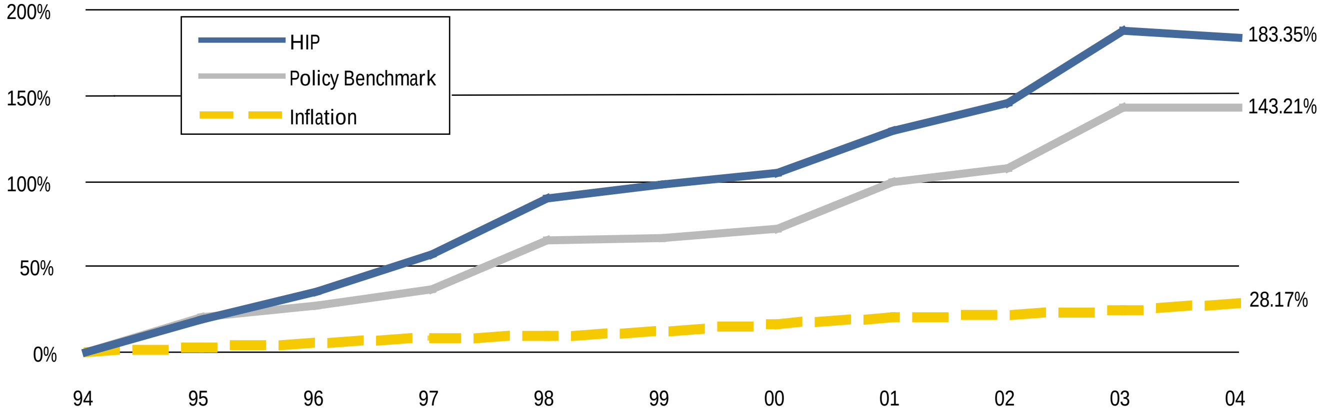
At year-end, fixed-income investments were 93.8% of HIP, with $59.9 million in market value. HIP's fixed-income investments returned (3.05%) during the year.

U.S. Government bonds constituted 57.9% of the fixed-income investments at year-end, while high-grade industrial bonds represented 14.1%, financial bonds 15.2%, Yankee bonds 7.7%, utility bonds 4.2%, and high yield bonds 0.9%. The weighted average maturity of the bond portfolio at year-end was approximately 17.4 years, the average duration was 9.6 years, and the average quality was AA, with 81.6% of the portfolio rated A or higher. The portfolio's five-year average annual turnover rate was 28.9%.

## EQUITY INVESTMENTS

The equity portion of HIP constituted 4.8% of the fund at year-end, with a market value of $3.0 million. HIP's equity portfolio was comprised primarily of REITS and electric utilities. HIP's common stocks returned 13.77% in the fiscal year, underperforming the broad equity market indices due to its concentration in higher-yielding, more defensive sectors.

HIP Cumulative Total Returns: Fiscal 1995-2004
Fiscal Periods Ending June 30

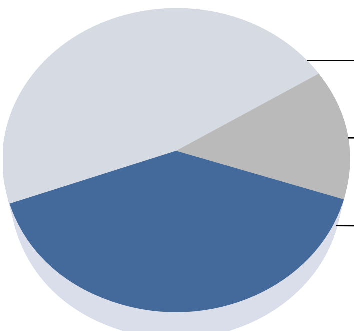


# Charitable Asset Management Pools

The Charitable Asset Management (CAM) Pools are used by The Regents of the University of California and the Campus Foundations for the investment of split-interest gifts, including charitable remainder trusts, pooled income funds and charitable gift annuities. The investment of these funds is directed by the Treasurer of The Regents; the administration of these funds is handled by the Charitable Asset Management group of State Street Global Advisors, Boston and San Francisco. The pools were created in November 2003.

At fiscal year end CAM assets totaled $122 million, with CAM Russell 3000 Tobacco Free (TF) Index Pool's market value at $57 million, The CAM EAFE International TF Index Pool's market value at $17 million, and the CAM Fixed Income Pool's market value at $48 million.

Total CAM Assets by Pool
June 30, 2004




## INVESTMENT OBJECTIVES

The CAM Russell 3000 TF Index Pool seeks to provide investment results that correspond to the total return (i.e. the combination of price changes and income) performance of a broad base of stocks publicly traded in the United States. The CAM EAFE International TF Index Pool seeks to provide investment results that correspond to the total return performance of Non-U.S. developed country stocks. The CAM Fixed Income Pool seeks to outperform the Lehman Aggregate Index and consistently have higher current income. The Funds' policy benchmarks are the Russell 3000 TF Index, MSCI EAFE + Canada TF Index and the Lehman Aggregate Index, respectively.

## RETURNS

Calendar year to date performance (six months) ending June 30, 2004 follows:

| Fund/Policy Benchmark | Return |
|---|---|
| CAM Russell 3000 TF Index Pool | 3.66% |
| Russell 3000 TF Index | 3.66% |
| CAM EAFE International TF Index Pool | 4.55% |
| MSCI EAFE + Canada TF Index | 4.30% |
| CAM Fixed Income Pool | 0.37% |
| Lehman Aggregate Index | 0.15% |

## JULES STEIN EYE INSTITUTE

Jules Stein
Eye Institute
David Geffen
School of
Medicine at UCLA

Los Angeles, CA

Established in 1966

The Jules Stein Eye Institute (JSEI) was the brain child of Dr. Bradley R. Straatsma, the inaugural chairman for UCLA's Department of Ophthalmology (and current emeritus faculty member), and Dr. Jules Stein, an ophthalmologist, philanthropist, businessman, and musician. In October 1961, with approval from the University of California Board of Regents, planning for a five-story building to accommodate space for an emergent Ophthalmology Department began.

True to his reputation as a "stickler for detail" and a "forward thinker," Dr. Stein meticulously planned every detail of JSEI's design, including the walls in the children's clinic tiled with ceramic squares created by The Walt Disney Company; the high-tech research laboratories, doctors' offices, and fully equipped surgical and outpatient examination suites; the patient rooms outfitted with television, radio, recorded music, and "talking books;" and the impressive bronze bust of his likeness, by sculptor Jacques Lipchitz, atop a marble pedestal in the foyer. JSEI was meant to be a timeless symbol of the man whose name it bears. Because of Dr. Stein's diligent groundwork, construction on the project did not begin until September 1964, with completion in November 1966.

Internationally acclaimed JSEI sits among the top-ranked David Geffen School of Medicine at UCLA and the Schools of Nursing, Dentistry, and Public Health. It houses UCLA's Department of Ophthalmology, as well as research laboratories and patient care facilities dedicated to advancing diagnostic and therapeutic technology in the vision sciences. As a complement to the original structure and essential for additional research space, the Doris Stein Eye Research Center was added in 1989. Together, the Stein buildings occupy more than 190,000 square feet within the UCLA Center for the Health Sciences. Yet the need for space has persisted, so soon to be added will be the Edie and Lew Wasserman Eye Research Center, a 100,000 square-foot building, to complete the original concept for the complex.

Fortunately for vision science, charitable supporters recognized and continue to foresee the fiscal needs for programs and activities such as those undertaken at the JSEI. From the first generous donations in 1960 that helped fund the original project and continuing today, contributions have provided millions of dollars for research, development, and expansion. For fiscal year 2003-2004, the University of California held assets mostly within the General Endowment Pool, but also within the High Income Pool, the Short-Term Investment Pool, and various fixed income securities and are currently valued at more than $24 million for JSEI Chairs; $15 million for research; $10 million for postdoctoral fellowships; $2 million for buildings and maintenance; and more than $160 million in unrestricted moneys for various other programs and activities. Overall, the income from the more than $200 million in endowment assets managed by the University of California, helped underwrite JSEI's programs and activities this past year.

Over the past 38 years, endowments at JSEI have provided essential financial assistance to faculty, doctors, and researchers who have identified new infections and diseases of the eye, developed and perfected diagnostic technologies, improved therapeutic techniques, and trained leading vision scientists throughout the nation and the world. For example, in 1967, three JSEI specialists uncovered the first breakthrough piece of ophthalmic research from UCLA with their discovery of the "renewal-shedding" phenomenon in retinal photoreceptor cells – work that eventually led to identifying malfunctions in the eye contributing to specific inherited forms of blindness. More recently, JSEI doctors and researchers were the first to recognize ocular manifestations of AIDS.

Along with its steadfast commitment to research, training, and health care delivery, JSEI is also known for its community service programs. Endowment funds help doctors, staff, and volunteers to promote vision education and provide patient care in schools and communities in general. Most notable is the UCLA Mobile Eye Clinic. Started in 1975, it delivers basic eye care services to children, senior citizens, and the economically disadvantaged in peripheral geographic locations in the Los Angeles area.

Dr. Stein's philanthropic endeavors in the field of vision helped move UCLA's medical school and the University of California to the forefront of science and medicine in the 20th century. This spirit of giving remains the cornerstone in JSEI's recognized position as an international leader in ophthalmology. Generous contributions from individuals, corporations, and foundations uphold the Stein legacy by providing vital support that will enable JSEI to consistently record noteworthy achievements for the benefit of healthy eyesight well into the 21st century.

We wish to acknowledge the help of The Jules Stein Eye Institute Development Office at UCLA. For more information on The Jules Stein Eye Institute visit their website at http://www.jsei.org.

The Short Term Investment Pool (STIP) is a cash investment pool established in fiscal 1976 by The Regents and is available to all University groups, including retirement and endowment funds. The STIP allows fund participants to maximize returns on their short-term cash balances by taking advantage of the economies of scale of investing in a larger pool and investing in a broader range of maturities. The STIP consists primarily of current funds slated for payroll, operating and construction expenses for all the campuses and teaching hospitals of the University. In addition, funds awaiting permanent investment are invested in the STIP to earn maximum daily interest until transferred.

## INVESTMENT OBJECTIVE

The STIP's investment objective is to maximize returns consistent with safety of principal, liquidity and cash-flow requirements. The STIP's investments include a broad spectrum of high-quality money-market and fixed-income instruments with a maximum maturity of five years. The Treasurer's Office structures investment maturities to ensure an adequate flow of funds to meet the University's cash requirements.

## INVESTMENT STRATEGY

The Treasurer's Office manages the STIP as a highly liquid portfolio, using maturity distribution strategies to maximize returns in different yield-curve environments. The Treasurer's Office also employs select swapping strategies by taking advantage of disparities in the market to improve quality and yield, while maintaining liquidity.

## RETURNS

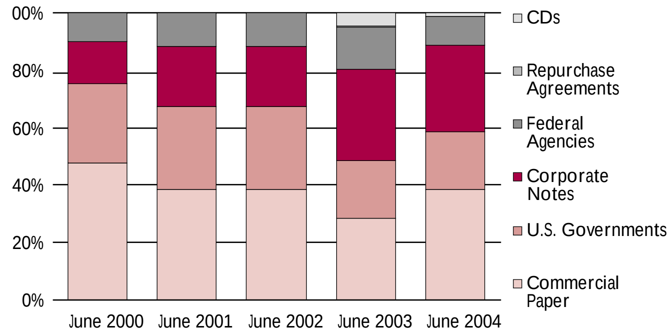
The STIP has achieved very attractive returns over the years. For fiscal 2004, the STIP's income return of 3.35% exceeded 2-Year U.S. Treasury Note income return at 1.73%. During the past 10 years, the average income return on the STIP was 5.59%, compared to 4.81% for 2-Year U.S. Treasury Note income return.

During the year, the STIP periodically provided liquidity to facilitate asset class rebalancing, in-flows and out-flows associated with University financing and other material liquidity events. During this period, selective high quality spread products in the 3-5 year maturities were added to enhance the portfolio's yield as the front end of the yield curve steepened. The average maturity of the portfolio was shortened with the expectation of higher interest rates going forward.

## ASSET MIX

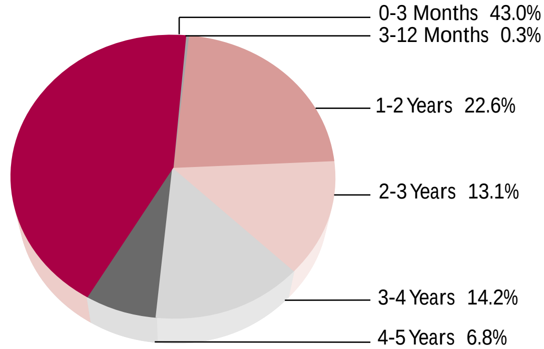
The STIP totaled $7.4 billion at June 30, 2004, compared to $6.8 billion at the end of fiscal 2003. The STIP's asset mix as of each of the past five fiscal year-ends and maturity distribution and quality mix as of June 30, 2004 follow.

STIP Asset Mix



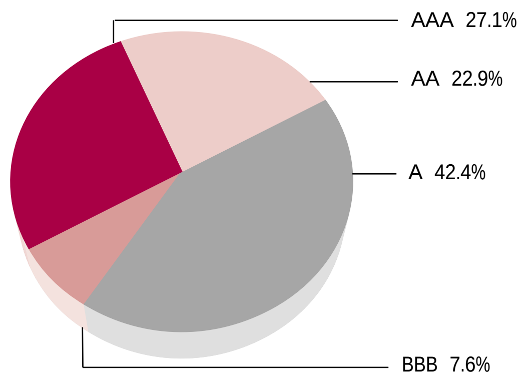

STIP Maturity Distribution

June 30, 2004 Average Maturity = 1.5 years




STIP Quality Mix

June 30, 2004 Average Quality = AA




(BBB and higher = investment grade)

### STIP ANNUALIZED INCOME RETURN[1]

June 30, 2004

| | 1-Year | 5-Year | 10-Year | 10-Year Cumulative |
|---|---|---|---|---|
| STIP[1] | 3.35% | 4.89% | 5.59% | 72.33% |
| 2-Yr U.S. Treasury Note Inc. | 1.73 | 3.70 | 4.81 | 59.28 |
| Inflation[2] | 3.27 | 2.68 | 2.51 | 28.17 |

[1] STIP's returns are net of (after) investment management and administrative expenses of 1.5% of average annual income for the fiscal year, which are automatically deducted from income.

[2] Inflation as measured by the Consumer Price Index.

## CHOOSING TO UTILIZE UC-MANAGED POOLS

As of June 30, 2004, the Treasurer's Office manages $714 million for the campus foundations and support groups. A donor has two avenues for making a gift to or establishing an endowment at the University of California: either directly to The Regents for a specific campus and/or purpose, or directly to a campus through its Foundation. The campus foundation trustees have discretion in their choice of investment managers and may use the Treasurer's Office or external investment managers.

The Treasurer's Office has worked with UC San Diego's Foundation since 1989, helping it manage the campus' private assets to promote and advance the university's mission.

"The UC San Diego Foundation has worked closely with the Treasurer's Office for over 15 years. We value their partnership with our Board and Investment/Finance Committee enormously. As the chair of the Committee, I can say without hesitation that the Treasurer's office has provided the Foundation with competitive returns, at attractive fees. The changes in the Treasurer's Office over the past few years have enhanced the diversity of our portfolio, reduced overall risk, and, we anticipate, will outperform the benchmarks. We appreciate their response to our requests for additional investment products and services which enable us to achieve our desired asset allocation. By having these services readily available, our members can devote their valuable time to development of private support and advocacy for the San Diego campus."

Dr. John D. Cambon '74
Principal, Commercial Bridge Capital
Chair, Investment and Finance Committee
UC San Diego Foundation

## UNIVERSITY PROGRAMS UTILIZING STIP

In fiscal 1985, The Regents authorized the University of California Mortgage Origination Program, which provides first deed of trust mortgage loans to eligible members of the University's faculty and staff. These loans totaled $44.1 million at June 30, 2004 and were funded by the legally available cash balances in the unrestricted portion of STIP. In March 1999, The Regents authorized the use of the legally available cash balances in the unrestricted portion of STIP to provide liquidity support for the University's Commercial Paper Program.

## UNIVERSITY OF CALIFORNIA RETIREMENT SYSTEM

Summary of Investments[1]
($ in thousands)

| | June 30, 2004 | | June 30, 2003 | |
|---|---|---|---|---|
| UC RETIREMENT PLAN (UCRP) | Market Value | % of UCRP | Market Value | % of UCRP |
| EQUITIES | | | | |
| U.S. Equity | $ 22,539,391 | 57.4% | $ 20,470,884 | 57.9% |
| Non-U.S. Equity | $ 3,253,511 | 8.3% | $ 2,603,919 | 7.4% |
| Private Equity | $ 561,583 | 1.4% | $ 531,347 | 1.5% |
| TOTAL EQUITIES | $ 26,354,485 | 67.1% | $ 23,606,150 | 66.8% |
| FIXED INCOME SECURITIES | | | | |
| Bonds | $ 10,382,678 | 26.4% | $ 10,088,082 | 28.5% |
| TIPS | $ 2,527,050 | 6.4% | $ 1,680,698 | 4.7% |
| TOTAL FIXED INCOME | $ 12,909,728 | 32.8% | $ 11,768,780 | 33.2% |
| LIQUIDITY PORTFOLIO | $ 25,159 | 0.1% | $ 2,139 | 0.0% |
| TOTAL UCRP | $ 39,289,372 | 100.0% | $ 35,377,069 | 100.0% |

| | June 30, 2004 | | June 30, 2003 | |
|---|---|---|---|---|
| DEFINED CONTRIBUTION (DC) FUNDS | Market Value | % of DC | Market Value | % of DC |
| TOTAL RETURN FUNDS | | | | |
| EQUITY FUND | $ 3,362,496 | 42.6% | $ 2,333,837 | 33.1% |
| BOND FUND | $ 941,111 | 11.9% | $ 975,992 | 13.8% |
| TIPS FUND (started 4/1/04) | $ 49,241 | 0.7% | NA | NA |
| INTEREST INCOME FUNDS | | | | |
| SAVINGS FUND | $ 2,943,607 | 37.3% | $ 3,094,570 | 43.8% |
| ICC FUND | $ 587,530 | 7.5% | $ 503,045 | 7.1% |
| TOTAL DC FUNDS[2] | $ 7,883,985 | 100.0% | $ 7,059,244[3] | 100.0%[3] |

The largest pool of assets managed by the Treasurer's Office is the University of California Retirement Plan (UCRP), created in 1961. UCRP is a defined benefit plan, whereby retirement benefits are a function of the employee's age, average salary and length of service. With the plan in surplus, The Regents suspended both employee and employer contributions to UCRP in 1990, but redirected the mandatory employee contributions to the newly established Defined Contribution Plan.

UCRP is a balanced portfolio of equities and fixed-income securities, which at June 30, 2004 totaled $39.3 billion, versus $35.4 billion at the end of fiscal 2003.

### INVESTMENT OBJECTIVE

The overall investment objective for all UCRP assets is to maximize real, long-term total returns (income plus capital appreciation adjusted for inflation), while assuming appropriate levels of risk.

1 For fiscal 2003 and fiscal 2004, the cash portion of the various portfolios excludes the unrealized market appreciation or depreciation of STIP investments, accounts receivable and accounts payable and the investments in the security lending collateral pool. Therefore, the balances differ from the University's Annual Financial Report. UCRP's STIP investments include assets associated with the UC PERS Voluntary Early Retirement Incentive Program totaling $71.5 million in fiscal 2003 and $76.2 million in fiscal 2004.

2 Total DC Funds excludes the Balanced Growth Fund (started 4/1/04), which totaled $729 million at June 30, 2004, and is invested in and reported as part of the Equity, Bond, and TIPS Funds.

3 Total DC Funds includes Money Market Fund which closed 4/1/04.

UCRP's specific objective is to ensure its ability to meet its obligation to beneficiaries by earning returns over the long term that meet or exceed the actuarial rate of return of 7.5%.

## INVESTMENT STRATEGY

In order to continue to achieve these investment objectives, The Regents adopted the following asset allocation policy in May 2003:

| Asset Class | Policy | Minimum | Maximum |
|---|---|---|---|
| U.S. Equity | 50% | 48% | 58% |
| Non-U.S. Equity | 7% | 5% | 9% |
| Private Equity | 5% | 3% | 7% |
| Fixed Income | 28% | 25% | 35% |
| TIPS | 5% | 3% | 7% |
| Real Estate | 5% | 0% | 7% |

The addition of a 5% allocation of Real Estate is expected to provide long-term risk-adjusted total returns between those of U.S. equities and bonds; diversification benefits given real estate's low correlation with other asset classes; protection against unanticipated inflation; and a high proportion of the total return derived from current income. The benchmarks for the individual asset classes are: Russell 3000 Tobacco Free (TF) Index for U.S. Equity; Morgan Stanley Capital International All Country World Index ex-U.S. for Non-U.S. Equity; Russell 3000 TF Index +3% for Private Equity; Citigroup Large Pension Fund (LPF) Index for Fixed Income; Lehman TIPS for TIPS; and NCREIF Property Index for Private Real Estate and the Wilshire REIT Index for Public Real Estate. The total fund benchmark is a policy-weighted average of the individual asset class benchmarks.

In November 2002, The Regents approved two core changes to the U.S. equity strategy: move from internal management to multiple external managers and diversify from a single actively managed large capitalization strategy to a range of equity strategies. The internally managed U.S. common stock was transferred into a Russell 3000 Tobacco Free Index fund managed by State Street Global Advisors, which is intended to mirror the returns of the broad U.S. stock market. During 2003-2004, UC began to hire active external managers, beginning with Small Capitalization and Large Capitalization strategies, and transferred some of these holdings out of the index fund.

In the Non-U.S. Equity category, 85% is invested in a MSCI EAFE + Canada Tobacco Free Index fund managed by State Street Global Advisors, designed to mirror the returns of the broad developed foreign stock markets. The remaining 15% is invested in emerging markets commingled institutional funds, to gain exposure to the developing foreign markets.

For Private Equity, the Treasurer's Office seeks opportunities through recognized top-tier venture capital partnerships and select buyout funds.

For Fixed Income investments, the Treasurer's Office analyzes relative value among the core benchmark sectors of Governments, Corporates, and Mortgage-backed securities and overweights those sectors and securities offering attractive real returns, while maintaining a risk level commensurate with the benchmark index.

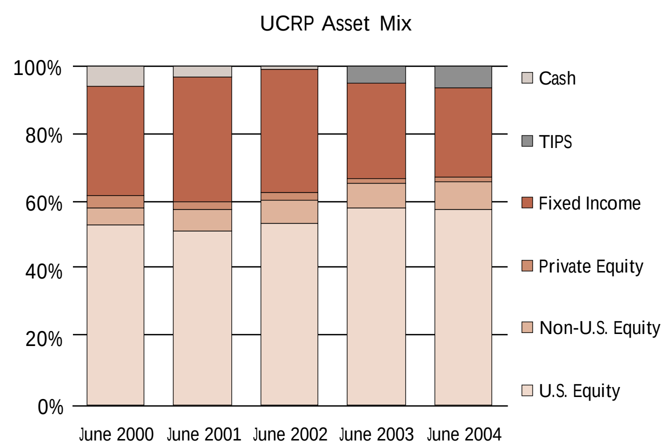
The Real Estate program will begin implementation in fiscal year 2004-2005.

## RETURNS

UCRP has exceeded its investment objectives over the long-term. It has also performed well versus its policy benchmarks. UCRP's return of 14.34% in the fiscal year reflects the strong performance of equities, buoyed by a rebounding global economy, along with flat bond market returns, as yields rose modestly. UCRP's annualized total return for the past 10 years through June 30, 2004 was 11.89%, outperforming its benchmark at 11.40%. The cumulative Total Returns Chart on page 28 illustrates the returns for UCRP for the past 10 years relative to the policy benchmark and inflation.

## ASSET MIX

The following illustrates UCRP's asset mix at each of the past five fiscal year ends.




## EQUITY INVESTMENTS

Total Equities represented 67.1% of UCRP at year-end, with a market value of $26.4 billion.

U.S. Equity represented 57.4% of the fund at year-end, with a market value of $22.5 billion. UCRP's U.S. Equity assets were indexed for the fiscal year and returned a strong 20.46%, in line with the benchmark return of 20.48%. UCRP's U.S. Equity return of 11.07% for the 10-year period underperformed the benchmark return of 12.19%.

Non-U.S. Equity represented 8.3% of UCRP at year-end, with a market value of $3.3 billion. UCRP's Non-U.S. Equities grew 32.43% in the fiscal year, outperforming the benchmark return of 32.03%. The longer-term returns for this asset class represent the emerging markets funds only, so comparisons are not yet meaningful.

## ALTERNATIVE INVESTMENTS

Private Equity represented 1.4% of UCRP at year-end with a market value of $562 million. This asset class returned 18.41% in the fiscal year, lagging public equity markets; however over the past 5 and 10 years UCRP's private equity returns of 14.03% and 26.14% have been an important contributor to total fund return. Longer-term, this category should provide attractive returns, although likely more modest than those of the previous decade.

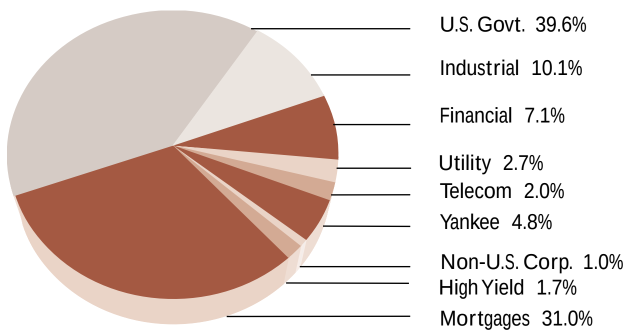
## FIXED-INCOME INVESTMENTS

At year-end, Fixed-Income investments constituted 32.8% of the portfolio, with a market value of $12.9 billion.

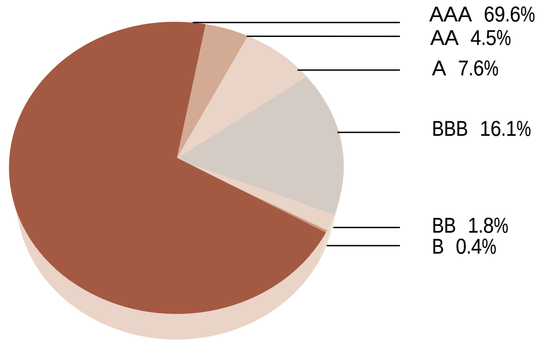
UCRP's fixed-income investments returned (0.83%) during the year, slightly below the benchmark return of (0.79%). Over the long-term, UCRP's fixed-income returns of 7.80% and 10.67% for the 5- and 10-year periods have exceeded the benchmark.

The weighted average maturity of the portfolio at the end of the year was approximately 12.1 years, the weighted average duration 7.1 years, and the average credit quality was AA, with more than 81% of the fixed-income securities rated A or higher. The following pie charts illustrate the sector mix and quality breakdown of the UCRP bond portfolio.

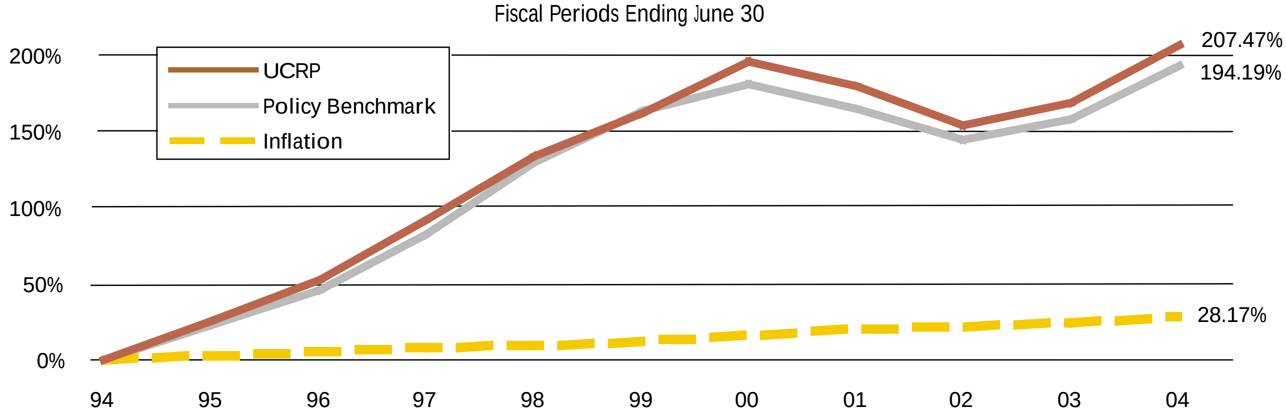
UCRP Fixed-Income Sector Mix
June 30, 2004

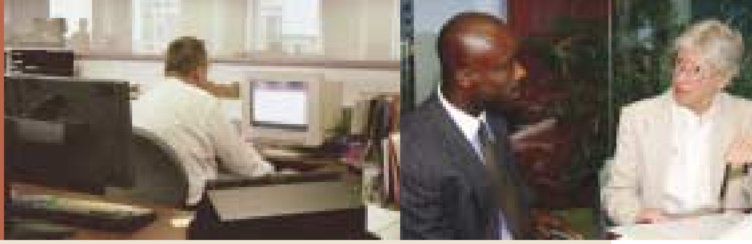



UCRP Fixed-Income Quality Mix
June 30, 2004
(BBB and higher = investment grade)




UCRP Cumulative Total Returns: Fiscal 1995-2004
Fiscal Periods Ending June 30





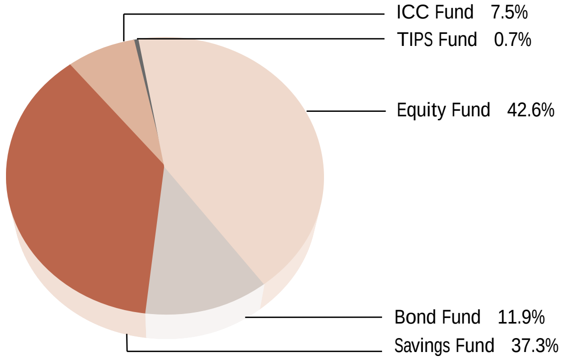
## UCRP ANNUALIZED TOTAL RETURNS[1] VERSUS BENCHMARKS AND INFLATION
June 30, 2004

| | 1-Year | 5-Year | 10-Year | 10-Year Cumulative | Benchmark Description[2] |
|---|---|---|---|---|---|
| **TOTAL FUND** | | | | | |
| UCRP | 14.34% | 3.19% | 11.89% | 207.47% | Total Fund Policy Benchmark: A blend of the indexes described in detail below, each weighted by the percentage it represents in the asset allocation. Adjustments have been made to reflect that the actual investment in Private Equity is below policy weight. Annual index returns assume monthly rebalancing. |
| Policy Benchmark | 14.05 | 2.15 | 11.40 | 194.19 | |
| Inflation | 3.27 | 2.68 | 2.51 | 28.17 | Inflation: Consumer Price Index. |
| **U.S. EQUITY** | | | | | |
| UCRP | 20.46% | (1.56)% | 11.07% | 186.14% | U.S. Equity Policy Benchmark: Russell 3000 TF Index; Historical: S&P 500 Index. |
| Policy Benchmark | 20.48 | (1.58) | 12.19 | 215.81 | |
| **NON-U.S. EQUITY** | | | | | |
| UCRP | 32.43% | (1.84)% | 1.12% | 11.21% | Non-U.S. Equity Policy Benchmark: MSCI AC World ex U.S. Index; Historical: MSCI EMF Index. |
| Policy Benchmark | 32.03 | (0.63) | (0.73) | (7.04) | |
| **PRIVATE EQUITY** | | | | | |
| UCRP | 18.41% | 14.03% | 26.14% | 920.10% | Private Equity Policy Benchmark: Russell 3000 TF Index + 3% (lagged by three months); Historical: S&P 500 Index + 5%. |
| Policy Benchmark | 41.90 | (1.32) | 15.10 | 308.34 | |
| **FIXED-INCOME SECURITIES** | | | | | |
| UCRP (Bonds) | (0.83)% | 7.80% | 10.67% | 175.26% | Fixed Income Policy Benchmark: Citigroup Large Pension Fund Index; Historical: LB LTG/C Index. |
| Policy Benchmark | (0.79) | 7.75 | 8.71 | 130.51 | |
| **TIPS** | | | | | |
| UCRP | 3.90% | N/A | N/A | N/A | |
| Policy Benchmark | 3.86 | N/A | N/A | N/A | TIPS Policy Benchmark: Lehman TIPS Index. |

In addition to the defined benefit program (UCRP), the University offers defined contribution plans to provide employees with supplemental retirement benefits—the mandatory Defined Contribution Plan (DC Plan), the Tax-Deferred 403(b) Plan, the Tax-Deferred 457(b) Plan (new as of October 1, 2004), and the Defined Contribution Plan After-Tax Account. These programs differ from UCRP in that the benefits received by participants are based on the employee's contributions to the plans and the returns earned on those contributions over time and that each participant chooses a mix of asset classes (funds) consistent with his or her own investment objectives and risk tolerance.

When investing their defined contribution funds, employees may choose among six University Defined Contribution (DC) Funds managed internally by the Treasurer's Office or selected external funds. The six University-managed funds include four total return funds—the Equity Fund, Bond Fund, TIPS Fund and Balanced Growth Fund—and two interest income funds—the Savings Fund and Insurance Company Contract (ICC) Fund.

Total UC-Managed Defined Contribution Plan Assets by Fund[3]
June 30, 2004




[1] UCRP's total returns are net of (after) investment management and administrative expenses of 0.04% of average annual market value. The asset class returns reflect investment returns. The performance of The Regents' total return investment portfolio is calculated by State Street Bank, according to the standard recommended by the Bank Administration Institute (BAI), which uses a time-weighted methodology that essentially neutralizes the effect of contributions and withdrawals so as to measure only the return on assets. These calculations comply with the CFA Institute's standards, which require time-weighted rates of return using realized and unrealized gains plus income. Performance is reconciled by the Treasurer's Office.

[2] Historical benchmark allocation information is available online at http://www.ucop.edu/treasurer/invret/Benchmarks.html.

[3] Includes balances invested for the Balanced Growth Fund, which at 6/30/04 totaled $729 million and consisted of 65% in the Equity Fund, 30% in the Bond Fund, and 5% in the TIPS Fund.

## INTERNALLY MANAGED UC FUNDS

University-managed funds offer employees the opportunity to achieve attractive, long-term investment performance by investing in one or more funds of their choice. These funds represent diversified portfolios of high-quality, growth-oriented global stocks and bonds, as well as more conservative interest income funds with attractive above market yields. As shown on page 31, these funds rank above average in performance comparisons for most time periods. In addition, the University-managed funds are extremely low cost relative to external fund options: Annual expenses are only 0.15% of average annual market value, compared to the industry average of 1.4%.[1]

## TOTAL RETURN FUNDS

### EQUITY FUND

The largest of the University-managed DC funds is the Equity Fund, established in August 1967. The Equity Fund is a total return fund with the primary objective of maximizing long-term capital appreciation with a moderate level of risk. The Regents adopted the following asset allocation policy for the Equity Fund in March 2000:

| Asset Class | Policy | Minimum | Maximum |
|---|---|---|---|
| U.S. Equity | 80% | 75% | 85% |
| Non-U.S. Equity | 15% | 10% | 20% |
| Private Equity | 5% | 3% | 7% |

At June 30, 2004, the total market value of the Equity Fund was $3.4 billion. The portfolio consisted of 82.5% U.S. Equity, 14.8% Non-U.S. Equity, 2.4% Private Equity and 0.3% cash.

In November 2002, The Regents approved two core changes to the U.S. equity strategy: move from internal management to multiple external managers and diversify from a single actively managed large capitalization strategy to a range of equity strategies. The internally managed U.S. common stock was transferred into a Russell 3000 Tobacco Free Index fund managed by State Street Global Advisors, which is intended to mirror the returns of the broad U.S. stock market. During fiscal year 2003-2004, UC issued RFPs to hire external managers starting with Small Capitalization and Large Capitalization strategies for the UCRP and the GEP. This plan will continue to be evaluated for possible inclusion within the Equity Fund. At June 30, 2004 all U.S. equity remained invested in the Russell 3000 TF Index fund. Non-U.S. equities currently utilizes a MSCI EAFE + Canada Tobacco Free Index fund and Emerging Markets funds.

For the fiscal year, the Equity Fund's return of 21.70% underperformed its policy benchmark return of 22.87%, but outperformed its peers, as measured by the Morningstar Domestic Equity Funds Median. The Equity Fund's longer-term returns are shown on page 31.

### BOND FUND

The Bond Fund is a total return fund established by The Regents in January 1978. The primary objective of the Bond Fund is to maximize real long-term total return through a combination of interest income and price appreciation, subject to maturity and quality constraints. The Treasurer's Office invests the Bond Fund in a diversified portfolio of primarily high-quality, debt securities.

At June 30, 2004, the total market value of the Bond Fund was $941 million. U.S. Treasury securities constituted 33.5% of the fund, high-grade industrials 8.5%, financial bonds 7.8%, high yield bonds 1.7%, Yankee bonds 3.8%, utility bonds 4.0%, mortgage-backed securities 35.2%, asset backed securities 4.2%, and cash 1.3%. The weighted average maturity of the portfolio at year-end was approximately 8.0 years, the weighted average duration 4.7 years, and 86% of the portfolio was rated A or better.

In fiscal 2004, the Bond Fund returned 0.10%, underperforming its benchmark and the Morningstar Taxable Bond Funds Median. As shown on page 31, the Bond Fund's long-term returns of 7.26% and 10.54% for the 5- and 10-year periods have exceeded those of its Morningstar peers and its benchmark by healthy margins.

### MULTI-ASSET FUND

The Regents closed the Multi-Asset Fund as of March 31, 2004 and replaced it with the Balanced Growth Fund.

### BALANCED GROWTH FUND

The Balanced Growth Fund, started April 1, 2004, seeks to provide long-term growth and income through a balanced portfolio of equity and fixed income securities held within UC-managed funds. The market value of the Balanced Growth Fund at June 30, 2004 was $729 million.

[1] Source: Morningstar, Inc. Although gathered from reliable sources, data completeness and accuracy cannot be guaranteed.

## UNIVERSITY-MANAGED DEFINED CONTRIBUTION FUNDS RETURNS[1]

June 30, 2004

| | 1-Year | 5-Year | 10-Year | Benchmark Description |
|---|---|---|---|---|
| Equity Fund | 21.70% | (0.49)% | 11.02% | Equity Fund Policy Benchmark: 85% less the actual Private Equity weight from the prior month end times the Russell 3000 TF Index, 15% MSCI ACWI ex US Index and the actual Private Equity weight of the previous month end times the Russell 3000 TF Index +3% (lagged by 3 months); Historical: S&P 500 Index. |
| Policy Benchmark | 22.87 | (1.52) | 12.22 | |
| Morningstar Domestic Equity Funds Median[2] | 19.27 | 1.20 | 10.11 | |
| Bond Fund | 0.10% | 7.26% | 10.54% | Bond Fund Policy Benchmark: Lehman Aggregate Index; Historical: LB LTG/C Index. |
| Policy Benchmark | 0.32 | 6.96 | 8.31 | |
| Morningstar Taxable Bond Funds Median[2] | 0.56 | 5.52 | 6.07 | |
| TIPS Fund (started 4/1/04) | NA | NA | NA | |
| Policy Benchmark | NA | NA | NA | TIPS Fund Policy Benchmark: Lehman TIPS Index. |
| Balanced Growth Fund (started 4/1/04) | NA | NA | NA | Balanced Growth Fund Policy Benchmark: 65% policy benchmark for Equity Fund, 30% policy benchmark for Bond Fund and 5% policy benchmark for TIPS Fund. |
| Policy Benchmark | NA | NA | NA | |
| Savings Fund | 4.11% | 5.26% | 5.79% | Savings Fund Policy Benchmark: 2-Year U.S. Treasury Note Income Return. |
| Policy Benchmark | 1.73 | 3.70 | 4.81 | |
| ICC Fund | 5.58% | 6.53% | 7.07% | ICC Fund Policy Benchmark: 5-Year U.S. Treasury Note Income Return. |
| Policy Benchmark | 3.20 | 4.49 | 5.33 | |
| Inflation | 3.27% | 2.68% | 2.51% | Inflation: Consumer Price Index. |

Contributions are invested according to a fixed ratio: 65% Equity Fund, 30% Bond Fund and 5% TIPS Fund (see below). The fund's asset allocation mix is a more aggressive mix than used in the Multi-Asset Fund (closed March 31, 2004). The Balanced Growth Fund's returns are a function of the performance of its component funds and are likely to closely mirror the performance of the University of California Retirement Plan (UCRP).

The Fund is rebalanced monthly. This will prevent the three component funds from growing outside their allocation percentage. The Treasurer's Office manages the component funds according to the investment objectives and strategies of those funds.

### TIPS FUND

The TIPS (Treasury Inflation-Protected Securities) Fund, started April 1, 2004, seeks to provide long-term total return and inflation protection consistent with an investment in U.S. Government inflation-indexed securities.

The Fund invests in inflation-protected securities issued by the U.S. Government. Inflation-indexed securities are designed to protect future purchasing power. The principal value is adjusted for changes in inflation and interest is paid on the inflation-adjusted principal.

The market value of the TIPS Fund at June 30, 2004 was $49 million.

[1] All returns and yields for the University-managed funds are net of (after) investment expenses of 0.15% and are based on unit values for the Equity, Bond and Multi-Asset Funds and on interest factors for the Savings, ICC and Money Market Funds. The Treasurer's Office calculates returns and yields by dividing the new unit value or interest factor by the previous unit value or interest factor supplied by UC Human Resources and Benefits. The Treasurer's Office compares these results to the gross investment returns calculated by State Street Bank. State Street Bank's calculations comply with the Association for Investment Management and Research (AIMR) standards, which require time-weighted rates of return using realized and unrealized gains plus income.

[2] Source: Morningstar, Inc. Although gathered from reliable sources, data completeness and accuracy cannot be guaranteed.

## INTEREST INCOME FUNDS

### SAVINGS FUND

The Savings Fund, the second largest DC fund, is an interest income fund created in July 1967. The investment objective of the Savings Fund is to maximize interest income returns, while protecting principal, in order to provide a safe, low-risk investment with attractive and stable returns. As such, the Savings Fund invests 100% in government, government-guaranteed and government agency securities of up to five years in maturity. The Treasurer's Office maximizes returns by altering the Fund's maturity structure in different yield curve environments.

The Savings Fund totaled $2.9 billion at June 30, 2004, and was invested 100% in AAA-rated U.S. Treasury and federal agency securities. The weighted average maturity of the Savings Fund was 2.4 years at June 30, 2004.

The Savings Fund has historically provided an income return greater than that of 2-year U.S. Treasury Note income. In fiscal 2004, the Savings Fund generated an income return of 4.11%, exceeding the 1.73% income return on 2-year U.S. Treasury Notes. During the past 10 years the Savings Fund generated an average income return of 5.79% versus 4.81% on 2-year U.S. Treasury Note income.

### INSURANCE COMPANY CONTRACT FUND

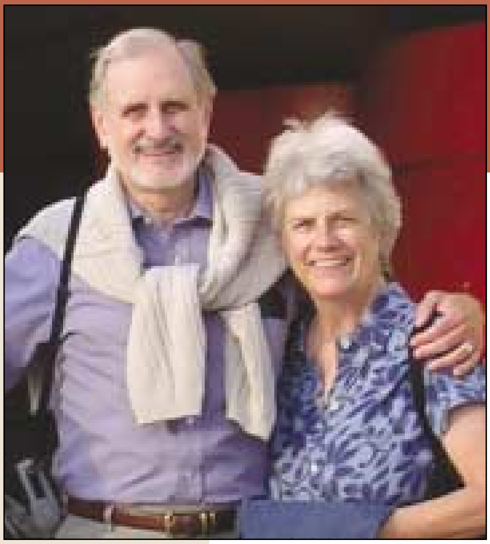
The Regents approved the Insurance Company Contract (ICC) Fund as an investment option in September 1985. The investment objective of the ICC Fund is to maximize interest income return while protecting principal. The Treasurer's Office invests contributions to the ICC Fund in insurance company contracts offered by select, highly rated, financially sound insurance companies. Under such contracts, the insurance companies guarantee a fixed annual rate of interest for a specified time period and the repayment of principal at the end of that time period. The contracts are backed by the assets of the insurance companies, and ICC Fund participants receive the blended rate of all contracts in the fund. The Treasurer's Office uses staggered maturities to systematically manage the reinvestment of maturing contracts and to provide return stability.

At June 30, 2004, the ICC Fund totaled $588 million, with a weighted average maturity of 3.5 years. Since inception, the ICC Fund has generated income returns that have exceeded those of 5-year U.S. Treasury Note income by a comfortable margin. In fiscal 2004, the ICC Fund generated a 5.58% income return versus 3.20% on 5-year U.S. Treasury Note income and during the past 10 years generated a 7.07% income return compared to 5.33% on 5-year U.S. Treasury Note income.

### MONEY MARKET FUND

The Regents closed the Money Market Fund as of March 31, 2004 due to low participation rates. Assets were merged into the Savings Fund (described above) which has had comparable risk-adjusted returns.

## RETIREE PROFILE



Duncan and Suzanne have endowed five Chairs at UCSB.

Duncan Mellichamp

Santa Barbara, CA

Professor of Chemical Engineering

36 years with the University of California Santa Barbara

To most people *retirement investments* are those investments made to offset anticipated retirement needs. But sometimes, it isn't just about providing for your own needs. For one retired University of California couple, *retirement investments* are those they have been able to make on behalf of the future of others. Duncan and Suzanne Mellichamp started out their careers with what they considered to be an "ordinary plan" for their retirement, the efforts of a couple of people born in the depression to make sure they never had it as hard as their parents. Yet, their ordinary plan has yielded extraordinary results. Their secret? Simply that they started saving and investing early.

In 1966, Duncan Mellichamp was a successful and satisfied research engineer with the DuPont Company in North Carolina. Yet, he couldn't resist the opportunity to become a founding member of the faculty of a fledgling chemical engineering program at the University of California Santa Barbara. He took advice that he continues to give to others to this day, "Look for the unorthodox path, it may offer you a way to make a special contribution. But, if that doesn't work for you, at least you won't be bored." Apparently he didn't get bored as he pursued what became a 36-year career at UCSB. Suzanne had already chosen a career in education, eventually spending nearly 30 years as an elementary school teacher. They note that when they moved to California it was easier for families to live on just one income. That allowed them to invest most of her salary (which was, in fact, larger than his as a beginning assistant professor) for that far-off day when they might use it.

Having started out as an engineer in industry, expecting to end up in management, Duncan's move to the university required a big shift in goals in that he initially had to focus on teaching and research exclusively. He grew to value his daily contact with 20- to 25-year old students, striving to understand their changing culture and vying to keep up with nimble minds. Along the way he established an enviable teaching and research record and co-authored a textbook that has been adopted worldwide.

Duncan continued to choose different paths such as active membership in the Academic Senate and the opportunity to learn about and work intensively on faculty retirement issues as a member of the UCSB and UC Faculty Welfare and Planning/Budget Committees. Duncan spent eight years on the UCRS Board, and chaired it for two years. In addition he served two years on the Board of Regents as Faculty Representative while heading the UC Academic Senate. All positions provided unique opportunities to view the institutional side of investment.

With Duncan's unusual "insider" background on the institutional side he is quick to point out that all UC employees have an easy opportunity to put some part of their savings into an investment program using UC-managed, Fidelity or Calvert funds. "The University's 403(b) plan provided a unique opportunity to invest and grow an account with pre-tax money. That may be one of the best deals around."

As for advice to others, Duncan cites the usual two conflicting mantras, "One, let your winners run and cut your losers; and two, invest your money and forget it. Being very busy, we depended perhaps too much on number two, which is just an admonition against *in-and-out trading*, and we might have spent more time following number one. For me, a busy professional career didn't allow for an active investment program. We felt it was better to put money into real estate and let the UC Treasurer manage the rest of our assets for the long term, letting him/her stay up late nights worrying. The best advice I can give is to start an investment program at the beginning of your working life, even if only a very modest one, so the benefits of compound growth in both knowledge and assets can work in your favor."

Duncan retired at age 66, yet he feels that he remains a part of UCSB by giving back. He and Suzanne watch with interest as the assets they recently invested in the University, five endowed professorships for promising mid-career faculty, begin to make a real difference at UCSB.

Duncan and Suzanne's retirement illustrates a plethora of unorthodox paths, all of which they are pursuing: he continues teaching, but part time; is active in a modest research program; is rebuilding his fluency in German; and has taken up digital photography. They are involved in a small vineyard owned with several other partners and travelling, as well. In 2003 Duncan was elected a trustee of The UCSB Foundation and a director of Opera Santa Barbara.

We wish to acknowledge the help of the UCSB Campus Human Resources staff in preparing this information.

This *Treasurer's Annual Report 2003-2004* is unaudited, however these investments are included in the following audited financial statements of the University of California: *The University of California Annual Financial Report 2003-2004* (available on the internet at www.ucop.edu/ucophome/busfin/reports.html), *The University of California Defined Contribution Plan and Tax-Deferred 403(b) Plan 2003-2004*, and *The University of California Retirement Plan 2003-2004* (both available on the internet at http://atyourservice.ucop.edu/forms_pubs/categorical/annual_reports.html).

## INTERNET LINKS OF INTEREST

UC-Managed Funds

Individual's Account Information: http://atyourservice.ucop.edu/

Portfolio Information: www.ucop.edu/treasurer

Regents' Committee on Investments/Investment Advisory Committee

Schedule and Agendas: www.universityofcalifornia.edu/regents/meeting.html

UC News

UC Newsroom: http://www.universityofcalifornia.edu/news/welcome.html

UC Human Resources and Benefits News: http://atyourservice.ucop.edu/

UC Office of the Treasurer News: http://www.ucop.edu/treasurer/updates/welcome.html

You may contact us in writing at the University of California, Office of the Treasurer,
P.O. Box 24000, Oakland, CA 94623-1000

www.ucop.edu/treasurer Email treas.regents@ucop.edu

# The Regents of the University of California

The University of California is governed by The Regents, a 26-member board, as established under Article IX, Section 9 of the California Constitution. The Treasurer of The Regents is responsible for managing the investments and cash for the University of California System. The Treasurer's Office carries out these activities under the policies established by the Investment Committee of The Regents of the University of California.

| | | |
|---|---|---|
| Officers of The Regents | The Honorable Arnold Schwarzenegger, President<br>John J. Moores, Chairman<br>Peter Preuss, Vice Chairman<br>James E. Holst, General Counsel and Vice President for Legal Affairs<br>Leigh Trivette, Secretary<br>David H. Russ, Treasurer and Vice President for Investments | |
| Ex Officio Regents | The Honorable Arnold Schwarzenegger, Governor of California<br>Cruz M. Bustamante, Lieutenant Governor<br>Fabian Núñez, Speaker of the Assembly<br>Jack O'Connell, State Superintendent of Public Instruction<br>Laurence Seigler, President of the Alumni Associations of the University of California<br>Barbara Bodine, Vice President of the Alumni Associations of the University of California<br>Robert C. Dynes, President of the University of California | |
| Appointed Regents | Richard C. Blum<br>Ward Connerly<br>Judith L. Hopkinson<br>Odessa P. Johnson<br>Joanne C. Kozberg<br>Sherry L. Lansing<br>David S. Lee<br>Monica C. Lozano<br>George M. Marcus | Velma Montoya<br>John J. Moores<br>Matt Murray, Student Regent<br>Gerald L. Parsky<br>Norman J. Pattiz<br>Peter Preuss<br>Haim Saban<br>Tom Sayles |
| Faculty Representatives | George Blumenthal | Lawrence Pitts |
| Regents-Designate | Jodi Anderson<br>Gary D. Novack | Mark F. Ornellas |
| Committee on Investments | Gerald L. Parsky, Chair<br>Richard C. Blum<br>Ward Connerly<br>David S. Lee, Vice Chair<br>Joanne Kozberg | Velma Montoya<br>Norman J. Pattiz<br>Peter Preuss<br>Haim Saban |
| | Ex Officio Members:<br>The Honorable Arnold Schwarzenegger<br>John J. Moores | Robert C. Dynes |
| | Advisory Members:<br>Jodi Anderson<br>George Blumenthal | Mark F. Ornellas |

# OFFICE OF THE TREASURER

June 2004

David H. Russ, MA – Treasurer and Vice President for Investments
Melvin L. Stanton, MBA – The Assistant Treasurer
Randolph E. Wedding, MBA – Managing Director – Fixed Income Investments
Marie N. Berggren, MS – Managing Director – Alternative Investments
Jesse L. Phillips, CFA, MBA, MA – Managing Director – Investment Risk Management
Robert B. Blagden, MBA – Managing Director – Externally-Managed Investments

## ALTERNATIVE INVESTMENTS

### Absolute Returns

| | |
|---|---|
| Steven Algert, CFA, MPPM | Director |

### Private Equity

| | |
|---|---|
| Neetesh Kumar, MBA, MS | Investment Officer |
| Brett Johnson, MBA | Investment Officer |
| Leslie Watson, BA | Analyst |

### Real Estate

| | |
|---|---|
| Jon Willis, MAI, MA | Investment Officer |

## EXTERNALLY-MANAGED INVESTMENTS

| | |
|---|---|
| Steven Algert, CFA, MPPM | Investment Officer |
| Burton Yuen, MBA | Investment Officer |

## FIXED INCOME INVESTMENTS

| | |
|---|---|
| Linda Fried, BA | Senior Portfolio Manager, Credit Sector |
| David Schroeder, BA | Senior Portfolio Manager, Governments Sector |
| Satish Swamy, CFA, MBA | Senior Portfolio Manager, Collateralized Sector |
| Alice Yee, MBA | Senior Portfolio Manager, Short-Term Securities |
| Aaron Staines, BA | Junior Portfolio Manager |
| Kim Evans, MBA | Head of Credit Analysis |
| Omar Sanders, CFA, MBA | Senior Credit Analyst |

## INVESTMENT RISK MANAGEMENT

| | |
|---|---|
| Aileen Liu, MS | Assistant Director |
| Alicia Boice, CFA, BS | Analyst |
| Carl Ports, CFA, BA | Analyst |

## OPERATIONS

| | | | |
|---|---|---|---|
| Robert Yastishak, Director | Floyd Gazaway, Jr. | Khaleelah Muhammad | Allen Woo |
| Angelica Beckman | Brian Hagland | Marjan Shomali | |
| Paula Ferreira, Supervisor | Jan Kehoe, Assistant Director | Michael Strach | |

## INFORMATION SYSTEMS

| | |
|---|---|
| Michael Comstock | Michael John |

## COMMUNICATIONS

| | |
|---|---|
| Susan Rossi, Manager | Alison Johnson |

## BUSINESS MANAGEMENT

| | |
|---|---|
| Nelson Chiu, Manager | William Byrd |

## ADMINISTRATIVE STAFF

| | | | |
|---|---|---|---|
| Gayle Tapscott, Manager | Burnita Bluitt | Milkah Cunningham | Joyce Lewis |
| Gay Adams | Kristina Chow | Claudia Green | Barbaretta Morris |
| Elizabeth Agbayani | | | |