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OFFICE OF THE AUDITOR GENERAL

California Legislature



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LOS ANGELES

August 1, 1978

Letter Report 715.8

The Honorable Speaker of the Assembly
The Honorable President pro Tempore
of the Senate
The Honorable Members of the Senate and the
Assembly of the Legislature of California

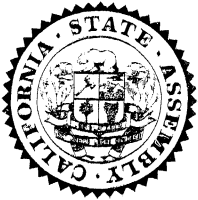
Members of the Legislature:

Your Joint Legislative Audit Committee respectfully forwards
the Auditor General's letter report reviewing the University
of California's investments.

The auditors are Ross Luna, Andrew P. Fusso, and Enrique G.
Farias.

Cordially,

MIKE CULLEN
Chairman



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July 28, 1978

Letter Report 715.8

Honorable Mike Cullen
Chairman, and Members of the
Joint Legislative Audit Committee
Room 5144, State Capitol
Sacramento, California 95814

Dear Mr. Chairman and Members:

In response to a resolution of the Joint Legislative Audit Committee, we have reviewed the investment policies of the University of California's (UC) Regents' Committee on Investments and the related procedures of the Treasurer of the UC Regents, who is responsible for administering the Committee's investment policies.

This report, the eighth* in a series, deals with the conduct and management of the UC investment portfolios which totaled \$1.8 billion as of June 30, 1977.

Section 21.4 of the By-Laws of the UC authorizes the Treasurer to manage the investment portfolios under the direction of the Committee on Investments. The Treasurer reports monthly on all security and investment transactions to the Committee and annually submits an investment report to the Regents.

* Earlier reports are U.C. Davis Child-Rearing Practices and Academic Abilities Research Project (Letter Report 715.1), August 1977; The Patent and Royalty Program of the University of California (Report 715.2), October 1977; The Foundations' Expenditures Need Review and Control (Report 715.3), December 1977; University of California's Management of Real Estate (Report 715.4), February 1978; Review of the University of California's Private Support Program (Report 715.5), June 1978; University of California Opportunity Fund (Report 715.6), July 1978; and Review of Certain Capital Outlays of the University of California (Report 715.7), July 1978.

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The Chief Accountant (Systemwide Administration) provides accounting services to the Treasurer for all aspects of the UC's investment operations. He reports the weighted average investments and rates of return, including income earned on the investments of all funds managed by the UC Treasurer.

The Bank of California, San Francisco office, acts by agreement as independent custodian of all securities owned and held by the UC Regents. The bank handles and controls the physical deliveries of securities, and the receipts and payments arising from sale or purchase of the securities by the UC.

Scope of Review

The scope of our work included (1) investment portfolio comparison between the University of California Retirement System (UCRS) with those of other comparable institutional investors such as the Public Employees Retirement System (PERS) and the State Teachers Retirement System (STRS), (2) review of UC short-term investment purchases and securities lending operations, and (3) possible conflicts of interest arising out of Regents' ownership or control over companies in which the UC invests.

Effective Rates of Return for All Combined UC Funds

The Treasurer of the Regents manages the following funds for the nine UC campuses: Retirement and Variable Annuity Funds; Endowment Fund; Current and Plant Funds; Debt Retirement, Renewal and Replacement Funds; Loan Fund; and the Short-Term Investment Pool.

Appendix A shows the total investable assets, annual investment income and resulting effective rates of return for all the combined funds in each of the fiscal years 1975-1977.

The yearly investment income (including net gain or loss on sales of investments) shows an upward trend from \$77.5 million in 1975 to \$86.8 million in 1976 and to \$99.3 million by the end of fiscal year 1977. These increases in investment income ranged between 12 percent and 14 percent yearly.

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INVESTMENT PORTFOLIO COMPARISON

The basic goal of any pension and retirement fund is to provide capital and income for the actuarial requirements of the fund. UCRS, PERS and STRS all have this basic goal in common.

We compared the UCRS's investment portfolio, including the Variable Annuity Plan, with the investment portfolios of PERS and the STRS. A summary of the comparison by types of investment securities is shown in Appendices B, C, D and E for fiscal years 1975-1977.

The results show that PERS and STRS are heavily invested in fixed-income securities while UC's concentration is in equities (i.e., common stock), reflecting the Regents' general investment policy. Investments are carried, if purchased, at cost or, if donated, at fair market or appraised value at date of acquisition.

Portfolio Composition Ratios

The composition of the UCRS investment portfolios was 56 to 62 percent equities and 38 to 44 percent fixed-income securities during fiscal years 1975-77. These ratios were a result of the UC Regents' general policy of investing approximately 70 percent of incoming funds in equities and the remainder in fixed-income securities until a 70-30 ratio is achieved. This policy has been unchanged since January 1974. Prior to 1974, the basic investment policy was 65 percent equities and 35 percent fixed-income securities.

As a result of the Regents' policy of placing 70 percent of new investments in stock holdings, the UCRS equity portfolio has increased from \$381 million in fiscal year 1975 to \$692 million in fiscal year 1977. This is an 82 percent increase in equity holdings over the two years. The Treasurer's staff believes that the 70 percent ceiling in equity investments of the UC will be reached within the next several years of operations.

Unlike UCRS, the PERS and STRS concentrate their investments in fixed-income securities. For the three-year period PERS showed ratios of 76 to 78 percent fixed-income securities and 22 to 24 percent equities, while STRS indicated very high ratios of 95 to 96 percent fixed-income portfolio, with only 4 to 5 percent equities. Section 20205.2 of the Government Code requires PERS to invest the assets of the retirement funds in an amount not to exceed 25 percent in common stocks or shares.

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Portfolio Income

As a result of UCRS's high equity ratios, the dividend income derived from equities from fiscal years 1975 to 1977 was less than that provided by fixed-income investments. For example, equity investment income received by UCRS during the three-year period amounted to \$59.8 million, which was \$21.6 million less than the total \$81.4 million in income provided by fixed-income investments (Appendix E).

As described earlier, and in contrast to UCRS investments, PERS and STRS' total investment portfolios are concentrated on fixed-income securities with average ratios of 77 and 95 percent, respectively. From this mix, the percentage of PERS and STRS' total income derived from fixed-income securities was 89 percent and 98 percent, respectively.

Portfolio Rates of Return

Any comparison of investment portfolio performance must consider many factors which affect the composition of a portfolio and its rate of return.

We did not attempt to analyze in detail the economic variables such as quality, predictability, risk and marketability of the investment portfolios of the three funds surveyed. These variable factors tend to influence the increase or decrease in the performance yields of any investment fund.

Although the last decade has been contrary to the long-term experience, the historic reason for investing in lower yielding equities has been that such investments usually better offset the effects of inflation than fixed-income investments. Equity security prices vary substantially more than fixed-income security prices because of the following two factors:

- Companies' earnings and dividends, like wages and prices, tend to increase as the value of the dollar decreases, whereas fixed-income securities, as the term connotes, remain relatively static because earnings are fixed
- Stock prices tend to follow the swings in the natural business cycle with averages, such as the Dow Jones industrials, bottoming-out at or near cyclical lows such as in 1966, 1970 and 1974.

To benefit from the latter phenomenon, it is necessary to risk trading tactics (e.g., attempt to buy when stocks are low and sell when prices are high) as distinguished from long-term investing tactics.

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Summarized below are the rates of return based on book values of the three retirement fund portfolios:

<u>Fund</u>	<u>FY 77</u>	<u>FY 76</u>	<u>FY 75</u>
UCRS	5.32%	5.25%	5.15%
PERS	6.36%	6.08%	5.90%
STRS	7.40%	7.10%	6.78%

UCRS has had consistently lower yearly yields which reflects the University's concentration in equity investments. The summary indicates, however, that all funds have been generally increasing their respective investment returns over the three-year period.

SHORT-TERM INVESTMENT PURCHASES

The Regents' Committee on Investments' written policies include directives specifying the types and composition of instruments which may appear in the UC short-term investment portfolio. The policies allow the Treasurer administrative flexibility to determine the amount and length of time of holding an investment.

We reviewed the cash balance management procedures employed by the UC Treasurer's Office in the daily purchase of short-term instruments during fiscal years 1976-77 and 1975-76. These investments include repurchase agreements, commercial papers, bank acceptances, certificates of deposits, U.S. Treasury bills and notes and other federal agencies securities. Short-term security purchases are summarized in Appendix F. Procedures were checked with established policies or directives of the Committee on Investments and found to be in compliance.

Potential to Increase Yield

The Treasurer's Office invests daily all cash funds in excess of immediate requirements.

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The average yield increases as the number of days in the maturity term of the securities increases. Therefore, investments in money market securities with maturity periods of 90 days or more generally yield increased interest income to the investor. By comparison, the tables show that PMIB invests more heavily in securities with maturities of 90 days to one year whereas the University preferred during this period those maturing in less than 90 days.

SECURITIES LENDING

Since 1967 the UC has engaged in lending investment securities to selected brokerage firms. Securities lending is a common practice among universities and other institutions, serving as a means of supplementing income and increasing returns on investments. By agreement, brokers borrow securities to meet trading and delivery commitments to cover short sales of securities to their customers; the lender receives a fee for this arrangement and retains the right to the security income.

Responsibility for the UC securities lending program is formally delegated to the Treasurer of the Regents as established by the policies of the Regents Committee on Investments. The Treasurer reports the securities lending transactions to the Committee monthly.

Since inception to the end of fiscal year 1976-77, UC payments for expenses incidental to the delivery of the loaned securities have aggregated to approximately \$40,000 against stipulations in the agreements. These charges for postage, insurance, transfer fees and taxes, and shipping charges should have been paid by the borrower and not by the lender.

We were told that the expenses for loaned securities with cash as collateral were treated differently from those of loaned securities with securities as collateral. The UC pays the charges for loaned securities with cash as collateral regardless of whether the securities were transferred to or returned by the brokers. When securities serve as collateral, the University pays the costs if the securities are transferred to the brokers while the brokers pay for such costs when securities are returned to the UC. This manner of paying expenses was, however, not provided in the existing agreements.

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The securities loan agreements between the brokers as borrowers and the UC as lender stipulate:

All transfer taxes and direct costs incidental to the transfer of the Securities by Lender to Borrower, and by Borrower to Lender upon the termination of the Loan, shall be paid by Borrower. If Lender shall incur any loss by reason of Borrower's failure to pay all said taxes and costs, Lender shall have the right from the Collateral, an amount sufficient to satisfy its claim against Borrower for said taxes and costs (emphasis added).

Because of expressed stipulations in the agreement concerning payment of the cost and expenses by the borrower, the UC should review their contractual arrangements with brokers.

CONFLICT OF INTEREST REQUIREMENTS

Our review of the UC investment portfolio disclosed investments by the University in the stocks of major corporations in which a Regent and an officer of the UC are also directors of one or more corporations.

The minutes of the Regents' Committee on Investments showed, however, that the Regent involved has abstained from voting and participating in investment decision-making in which he has financial interest. The officer involved was not a member of the Committee on Investments, never attended any meetings of the Committee where the subject firm was discussed and has since accepted an appointment to the academic staff at the University.

The State Legislative Counsel, in an opinion dated May 9, 1978, stated that the UC Board of Regents qualifies as a state agency under the provisions of the State of California's Political Reform Act of 1974 and, therefore, the Board must adopt and promulgate a conflict of interest code.

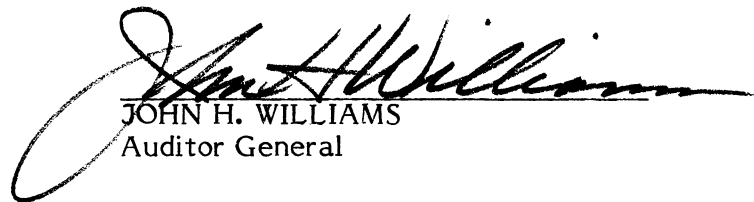
We reviewed the pertinent provisions of the recently adopted UC Conflict of Interest Code as they affect the Regents and officers of the University. Under such Code, the members of the UC Board of Regents and designated university officials must now file financial disclosure statements as a matter of public record and under certain circumstances are required to disqualify themselves from participating in decision-making in which they have financial interests.

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CONCLUSION

The University of California has investment portfolios with an aggregate value in excess of \$1.8 billion. The composition of its portfolios is approximately 60 percent equities and 40 percent fixed-income securities. The portfolio rate of return on UCRS investments is less than PERS and STRS due to the UC's high equity ratio. The short-term portfolio holdings of the UC are shifting to a longer maturity term (90 days-1 year) with a corresponding increase in yield. The security lending practices of the University need review to insure that contractual relationships with brokers are being adhered to. We found no evidence of conflict of interest involving investment decisions on the part of Regents or officers of the University.

Respectfully submitted,


JOHN H. WILLIAMS
Auditor General

Staff: Ross Luna
Andrew P. Fusso
Enrique G. Farias

Attachments:

- Appendix A--University of California Effective Rates of Return on All Funds Included in UC Investments Portfolio Fiscal Years 1975 to 1977
- Appendix B--University of California Comparison of Investment Portfolios Fiscal Year 1976-77
- Appendix C--University of California Comparison of Investment Portfolios Fiscal Year 1975-76
- Appendix D--University of California Comparison of Investment Portfolios Fiscal Year 1974-75
- Appendix E--University of California Income and Average Yield of Investment Portfolio
- Appendix F--University of California Short-Term Investments Purchase Fiscal Years 1976-77 and 1975-76

UNIVERSITY OF CALIFORNIA
COMPARISON OF INVESTMENT PORTFOLIOS
FISCAL YEAR 1976-77
(IN MILLIONS OF DOLLARS)

<u>Type of Investment</u>	<u>UCRS</u>		<u>STRS</u>		<u>PERS</u>	
	<u>Book Value</u>	<u>%</u>	<u>Book Value</u>	<u>%</u>	<u>Book Value</u>	<u>%</u>
Fixed-Income Securities						
Bonds						
Government	\$ 30.5	3	\$ 687.5	14	\$ 817.4	9
Public utility and transportation	177.6	16	1,524.0	32	2,046.1	24
Financial	10.9	1	304.0	6	513.8	6
Industrial and miscellaneous	<u>73.6</u>	<u>6</u>	<u>660.1</u>	<u>14</u>	<u>870.1</u>	<u>10</u>
	292.6	26	3,175.6	66	4,247.4	49
Mortgages						
FHA-VA	24.6	2	175.4	3	699.8	8
GNMA	-	-	1,105.0	23	1,356.8	15
Commercial	<u>15.9</u>	<u>1</u>	<u>43.0</u>	<u>1</u>	<u>253.7</u>	<u>3</u>
	40.5	3	1,323.4	27	2,310.3	26
Bond substitutes						
Utilities	<u>85.5</u>	<u>8</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>
Total Fixed-Income Securities	<u>418.6</u>	<u>37</u>	<u>4,499.0</u>	<u>93</u>	<u>6,557.7</u>	<u>75</u>
Equities						
Common stock	681.2	61	175.0	4	2,026.0	23
Preferred stock	<u>10.7</u>	<u>1</u>	<u>-</u>	<u>-</u>	<u>44.5</u>	<u>1</u>
Total Equities	<u>691.9</u>	<u>62</u>	<u>175.0</u>	<u>4</u>	<u>2,070.5</u>	<u>24</u>
Total long-term portfolio	<u>1,110.5</u>	<u>99</u>	<u>4,674.0</u>	<u>97</u>	<u>8,628.2</u>	<u>99</u>
Short-term portfolio	<u>14.8</u>	<u>1</u>	<u>147.0</u>	<u>3</u>	<u>96.0</u>	<u>1</u>
Total Portfolio	<u>\$1,125.3</u>	<u>100</u>	<u>\$4,821.0</u>	<u>100</u>	<u>\$8,724.2</u>	<u>100</u>

UNIVERSITY OF CALIFORNIA
COMPARISON OF INVESTMENT PORTFOLIOS
FISCAL YEAR 1975-76
(IN MILLIONS OF DOLLARS)

Type of Investment	UCRS		STRS		PERS	
	Book Value	%	Book Value	%	Book Value	%
Fixed-Income Securities						
Bonds						
Government	\$ 24.6	2	\$ 695.0	17	\$ 799.0	10
Public utility and transportation	149.8	15	1,481.8	35	2,046.5	27
Finance	9.9	1	203.3	5	417.1	13
Industrial and miscellaneous	<u>64.9</u>	<u>7</u>	<u>724.0</u>	<u>17</u>	<u>977.0</u>	<u>5</u>
	249.2	25	3,104.1	74	4,239.6	55
Mortgages						
FHA-VA	28.0	3	171.5	4	696.3	9
GNMA	-	-	563.0	14	669.0	9
Commercial	<u>16.7</u>	<u>2</u>	<u>43.4</u>	<u>1</u>	<u>236.0</u>	<u>3</u>
	44.7	5	777.9	19	1,601.3	21
Bond substitutes						
Utilities	<u>67.7</u>	<u>7</u>	-	-	-	-
Total Fixed Income Securities	<u>361.6</u>	<u>37</u>	<u>3,882.0</u>	<u>93</u>	<u>5,840.9</u>	<u>76</u>
Equities						
Common stock	548.5	55	188.8	5	1,692.1	21
Preferred stock	<u>6.7</u>	<u>1</u>	<u>0.5</u>	-	<u>41.0</u>	<u>1</u>
Total Equities	<u>555.2</u>	<u>56</u>	<u>189.3</u>	<u>5</u>	<u>1,733.1</u>	<u>22</u>
Total long-term portfolio	916.8	93	4,071.3	98	7,574.0	98
Short-term portfolio	<u>73.5</u>	<u>7</u>	<u>100.4</u>	<u>2</u>	<u>134.7</u>	<u>2</u>
Total Portfolio	<u>\$990.3</u>	<u>100</u>	<u>\$4,171.7</u>	<u>100</u>	<u>\$7,708.7</u>	<u>100</u>

UNIVERSITY OF CALIFORNIA
COMPARISON OF INVESTMENT PORTFOLIOS
FISCAL YEAR 1974-75
(IN MILLIONS OF DOLLARS)

Type of Investment	UCRS		STRS		PERS	
	Book Value	%	Book Value	%	Book Value	%
Fixed-Income Securities						
Bonds						
Government	\$ 16.8	2	\$ 370.8	10	\$ 465.4	7
Public utility and transportation	139.5	17	1,537.8	42	2,113.9	31
Financial	15.6	1	178.9	6	415.4	6
Industrial and miscellaneous	<u>64.8</u>	<u>8</u>	<u>751.4</u>	<u>21</u>	<u>975.8</u>	<u>14</u>
	236.7	28	2,838.9	79	3,970.5	58
Mortgages						
FHA-VA	31.4	4	184.6	5	738.1	11
GNMA	-	-	261.2	7	250.3	4
Commercial	<u>18.6</u>	<u>2</u>	<u>43.7</u>	<u>1</u>	<u>231.9</u>	<u>3</u>
	50.0	6	489.5	13	1,220.3	18
Bond substitutes						
Utilities	<u>55.6</u>	<u>7</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>
Total Fixed-Income Securities	342.3	<u>41</u>	3,328.4	<u>92</u>	5,190.8	<u>76</u>
Equities						
Common stock	472.8	57	187.1	5	1,465.6	21
Preferred stock	<u>4.0</u>	<u>1</u>	<u>0.5</u>	<u>-</u>	<u>42.3</u>	<u>1</u>
Total Equities	<u>476.8</u>	<u>58</u>	<u>187.6</u>	<u>5</u>	<u>1,507.9</u>	<u>22</u>
Total long-term portfolio	819.1	99	3,516.0	97	6,698.7	98
Short-term portfolio	<u>11.3</u>	<u>1</u>	<u>93.8</u>	<u>3</u>	<u>154.6</u>	<u>2</u>
Total Portfolio	\$ <u>830.4</u>	<u>100</u>	\$ <u>3,609.8</u>	<u>100</u>	\$ <u>6,853.3</u>	<u>100</u>

INCOME AND AVERAGE YIELD OF INVESTMENT PORTFOLIO
(IN MILLIONS OF DOLLARS)

APPENDIX E

Type of Investment	UCRS			Fiscal Year 1976-77 STRS			PERS		
	Income	Percent of Total	Average Yield (Percent)	Income	Percent of Total	Average Yield (Percent)	Income	Percent of Total	Average Yield (Percent)
Fixed-Income - long term	\$28.7	50	7.50	\$313.6	96	8.25	\$460.1	87	8.26
Fixed-Income - short-term	4.0	7	6.04	6.2	2	5.25	9.9	2	5.06
Equities	<u>24.7</u>	<u>43</u>	<u>3.83</u>	<u>6.5</u>	<u>2</u>	<u>5.30</u>	<u>59.2</u>	<u>11</u>	<u>3.58</u>
Total Portfolio	<u>\$57.4</u>	<u>100</u>	<u>5.32</u>	<u>\$326.3</u>	<u>100</u>	<u>7.40</u>	<u>\$528.2</u>	<u>100</u>	<u>6.36</u>
Fixed-Income - long-term	\$24.9	55	7.85	Fiscal Year 1975-76			\$388.8	88	8.53
Fixed-Income - short-term	0.7	2	6.43	\$259.6	96	8.49	7.9	2	5.45
Equities	<u>19.6</u>	<u>43</u>	<u>3.69</u>	<u>5.3</u>	<u>2</u>	<u>3.60</u>	<u>45.2</u>	<u>10</u>	<u>2.02</u>
Total Portfolio	<u>\$45.2</u>	<u>100</u>	<u>5.25</u>	<u>\$271.1</u>	<u>100</u>	<u>7.10</u>	<u>\$441.9</u>	<u>100</u>	<u>6.08</u>
Fixed-Income - long-term	\$22.0	57	8.13	Fiscal Year 1974-75			\$332.8	87	8.86
Fixed-Income - short-term	1.1	3	9.80	\$213.2	95	9.11	7.4	2	7.50
Equities	<u>15.5</u>	<u>40</u>	<u>5.92</u>	<u>4.5</u>	<u>2</u>	<u>2.85</u>	<u>40.3</u>	<u>11</u>	<u>2.23</u>
Total Portfolio	<u>\$38.6</u>	<u>100</u>	<u>5.15</u>	<u>\$225.0</u>	<u>100</u>	<u>6.78</u>	<u>\$380.5</u>	<u>100</u>	<u>5.90</u>
Three year total									
Fixed-Income-long-term	\$75.6	54		\$786.4	96		\$1,181.7	87	
Fixed-Income-short-term	5.8	4		19.7	2		24.2	2	
Equities	<u>59.8</u>	<u>42</u>		<u>16.3</u>	<u>2</u>		<u>144.7</u>	<u>11</u>	
Total Portfolio	<u>\$141.2</u>	<u>100</u>		<u>\$822.4</u>	<u>100</u>		<u>\$1,350.6</u>	<u>100</u>	

UNIVERSITY OF CALIFORNIA
SHORT-TERM INVESTMENTS PURCHASE
FISCAL YEARS 1976-77 AND 1975-76

Type of Short-Term Securities	1976-1977			1975-1976		
	Amount Invested (In Million of Dollars)	Average Per Day (In Million of Dollars)	Percentage of Purchases	Amount Invested (In Million of Dollars)	Average Per Day (In Million of Dollars)	Percentage of Purchases
Commercial Paper						
Prime industrial and utility	\$ 746.9	\$ 2.1	14.7	\$ 675.5	\$ 1.9	20.1
Prime finance	<u>742.1</u>	<u>2.1</u>	<u>14.6</u>	<u>811.1</u>	<u>2.2</u>	<u>24.2</u>
	1,489.0	4.2	29.3	1,486.6	4.1	44.3
Repurchased Agreements	2,928.6	8.1	57.6	1,506.7	4.2	44.9
Bank Acceptances	410.0	1.1	8.1	183.0	0.5	5.5
Certificates of Deposits	195.1	0.5	3.8	155.3	0.5	4.6
U.S. Treasury Bills and Notes	29.3	0.1	0.6	14.0	0.0	0.4
Other Federal Agencies Securities	<u>30.9</u>	<u>0.1</u>	<u>0.6</u>	<u>8.1</u>	<u>0.0</u>	<u>0.3</u>
Total Purchases	<u>\$5,083.4</u>	<u>\$14.1</u>	<u>100.0</u>	<u>\$3,353.7</u>	<u>\$9.3</u>	<u>100.0</u>

UNIVERSITY OF CALIFORNIA
EFFECTIVE RATES OF RETURN ON ALL FUNDS
INCLUDED IN UC INVESTMENTS PORTFOLIO
FISCAL YEARS 1975 TO 1977
(DOLLARS IN THOUSANDS)

	Formula	Fiscal Year 1977	Fiscal Year 1976	Fiscal Year 1975
<u>Investment Income (Gross)</u>	<u>I</u>	\$ 99,337	\$ 86,754	\$ 77,517
Beginning Investable Assets:				
Securities at book value		\$1,272,664	\$1,098,819	\$ 959,706
Temporary investments		371,370	323,425	311,631
Accrued interest and dividends		9,219	6,764	5,542
Cash		22,131	12,483	10,490
Accounts payable on investment purchases, including claims filed and in process		(5,215)	(3,246)	(3,202)
<u>Investable Assets, Beginning of Year</u>	<u>A</u>	<u>\$1,670,169</u>	<u>\$1,438,245</u>	<u>\$1,284,167</u>
Ending Investable Assets:				
Securities at book value		1,415,933	1,272,664	1,098,819
Temporary investments		423,054	371,370	323,425
Accrued interest and dividends		11,553	9,219	6,764
Cash		5,675	22,131	12,483
Accounts payable on investments purchases, including claims filed and in process		(1,291)	(5,215)	(3,246)
<u>Investable Assets, End of Year</u>	<u>B</u>	<u>\$1,854,924</u>	<u>\$1,670,169</u>	<u>\$1,438,245</u>
<u>Effective Rate of Return</u>	$\frac{I}{\frac{A+B}{2} - \frac{I}{2}}$	<u>5.80%</u>	<u>5.74%</u>	<u>5.86%</u>

July 28, 1978

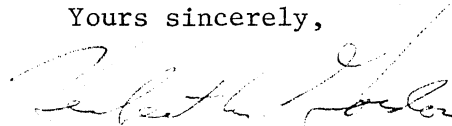
The Regents believe that investment in common stocks will provide more spendable dollars and preserve greater purchasing power over a long period of time than placing the same dollars in bonds.

It is true that the current return on a short maturity in the short term portfolio is generally lower than an investment in a longer maturity. But in a falling market (with interest rates rising) it is most prudent to stay as short as possible to obtain higher rates as soon as possible when reinvesting matured securities. With short term rates having risen from 4.65% to 7.85% on 90-day commercial paper in as short a period as 1½ years from January 1977 to the present we believe the policy has been correct over a period of time, although it may appear to be disadvantageous at any one point.

With regard to The Regents absorbing what appears to be approximately \$40,000 in costs in connection with securities lending, we believe the misunderstanding relates to interpretation of the word "transfer" in the agreements between The Regents and brokers. "Transfer taxes" and "costs incidental to the transfer of securities" do not necessarily include postage and insurance. If the agreements required the broker to pay postage and insurance The Regents would be out of phase with the trade and therefore would be foregoing its opportunity to add an additional increment to the overall investment return.

We should like merely to say that working with your auditors has been a stimulating experience for the Treasurer of The Regents and his staff, and we would be pleased to cooperate fully with the Auditor General and his staff if in the future we may have the opportunity of working together again.

Yours sincerely,



Herbert M. Gordon
Treasurer of The Regents

cc: President Saxon
Director of Audits Norman Gross

THE REGENTS OF THE UNIVERSITY OF CALIFORNIA

OFFICE OF THE TREASURER



HERBERT M. GORDON
Treasurer

JACK N. SCHAPPELL
Assistant Treasurer-Real Estate

PATRICIA A. SMALL
Assistant Treasurer-Investments

615 University Hall
2200 University Avenue
Berkeley, California 94720

July 28, 1978

The Honorable John H. Williams
Auditor General
State of California
925 L Street
Sacramento, CA 95814

Dear Mr. Williams:

This is in response to your letter of July 25 enclosing a draft of your report to the Joint Legislative Audit Committee in connection with University of California Investment Policies.

We are generally in agreement with the conclusions of the Report as stated. However, some clarification of what is meant by "rate of return" and "yield" may be in order.

It is true that the current rate of return on UCRS investments is lower than PERS and STRS because of the different mixes of common stocks versus fixed income investments. However, this lower current return is acceptable under the general investment policy of The Regents because it is believed that over the long periods involved in pension fund investing, the total rate of return on common stocks will be greater than on bonds. For example, if a stock is bought at \$50 per share and has a \$2 per annum dividend in the first year, its current yield on cost is 4%. Bonds have current returns around 9%. However, if the \$2 dividend on the common stocks goes up 10% per annum and the value of the \$50 common stock rises 10% per annum in accordance with the company's earning power growth, the total return of the common stock would be 14% compared to a total return on the bond of 9%. On the bond there would be no increase in dollar value at the end of the 30 year period but under the assumptions noted above, the \$50 stock would be worth \$872. Also, at the end of the 30 year period the common stock dividend would have risen to \$34.90 producing a yield on cost of 69.80%. Even with a lower growth rate, say 6% per annum, the \$50 stock would have a terminal value of \$287 after 30 years and would yield nearly 23% on cost. If inflation is higher at the end of 30 years there would be a loss in the purchasing power of the original dollars which went into the bond. It should be noted also that most bond investments are subject to call, i.e. were interest rates to decline during the next 30 years, it is likely that 9% bonds would be called and replaced by bonds which would yield appreciably lower rates of return.

Honorable Mike Cullen
 Chairman, and Members of the
 Joint Legislative Audit Committee
 July 28, 1978
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The UC's investments in short-term securities are concentrated in mostly 1 to 3-day repurchase agreements and 1 to 90-day commercial paper.

A comparison of the short-term portfolio holdings between the UC and the State Pooled Money Investment Board (PMIB) is shown under the following analysis tables:

June 30, 1976 Portfolio

<u>Term to Maturity</u>	<u>Average Yield</u>	<u>PMIB</u>		<u>UC</u>	
		<u>Cost (000 Omitted)</u>	<u>% of Portfolio</u>	<u>Cost (000 Omitted)</u>	<u>% of Portfolio</u>
Under 10 days	5.54%	\$ 123,883	3.5	\$ 98,359	29.5
10-29 days	5.64	375,719	10.5	65,950	19.8
30-89 days	5.65	1,051,758	29.3	144,288	43.3
90 days - 1 year	5.78	1,393,514	38.8	11,465	3.4
1 year - 3 years	6.50	366,164	10.2	9,000	2.7
Over 3 years	8.07	<u>278,141</u>	<u>7.7</u>	<u>4,461</u>	<u>1.3</u>
Total		<u>\$3,589,179</u>	<u>100.0</u>	<u>\$333,523</u>	<u>100.0</u>

June 30, 1977 Portfolio

Under 10 days	5.39	\$ 749,039	11.6	\$122,201	31.5
10-29 days	5.48	683,378	10.6	53,100	13.7
30-89 days	5.61	1,350,063	20.8	115,397	29.7
90 days - 1 year	5.67	2,037,161	31.4	87,777	22.6
1 year - 3 years	6.37	891,376	13.8	8,000	2.1
Over 3 years	7.47	<u>767,401</u>	<u>11.8</u>	<u>1,752</u>	<u>0.4</u>
Total		<u>\$6,478,418</u>	<u>100.00</u>	<u>\$388,227</u>	<u>100.0</u>