1. **CALL TO ORDER/ROLL CALL**
Chair Wüstenberg called the meeting of the Investment Committee to order at 12:35 p.m.

On roll call, the following Investment Committee members answered present:
Ms. Leslie Lehmann
Ms. Phyllis Wüstenberg

Absent: Mr. Kerry Barnett (business conflict).

**Other Board Members Present:** Bridget Burns and Rachel Pilliod.

**Chancellor’s Office staff present:** Senior Vice Chancellor Tom Anderes, Mike Green, Mark Johnson, Marcia Stuart, and Virginia Thompson.

**Others:** Marcia Beard, RV Kuhns; Mike Mueller, Oregon State Treasury, Neil Collins, Quellos Capital Management, LP; Laura Gaylord, RREEF (via telephone); Frank Garcia, RREEF America II (via telephone).

2. **APPROVAL OF MINUTES**
   - July 17, 2003, Investment Committee Meeting Minutes

The Committee dispensed with the reading of the July 17, 2003, Committee meeting minutes. Director Lehmann moved and Director Wüstenberg seconded the motion to approve the minutes as submitted. The following voted in favor: Directors Lehmann, and Wüstenberg. Those voting no: none. Motion approved unanimously.

3. **REPORT ITEMS**
   a. **Fourth Quarter Investment Report for FY 2003**

Due to time constraints and the scheduled interviews of investment firms, this item was not discussed.

   b. **Absolute Return Strategies**

Ms. Beard introduced Mr. Neil Collins from Quellos Capital Management, L.P. Mr. Collins provided a briefing on Quellos’ for absolute return strategy (ARS) evolution and investment philosophy.
Quellos was founded in late 1994, and in the nine years following has established offices in Seattle, New York, San Francisco, Los Angeles, and London with approximately 35 specialists involved in the management of ARS assets (to include portfolio management, qualitative and quantitative research, and risk management). Quellos currently has assets in excess of $7.5 billion under management with a broadly diversified investor base. Since inception (August 1995) through July 2003, Quellos’ Appreciation Composite (focused on Absolute Return Strategies) produced high rates of return with low risk: annualized net returns in excess of 13 percent, standard deviation of less than 5 percent, and a Sharpe Ratio greater than 2.0. Quellos’ staff has an average of 17 years of experience in Absolute Return Strategies by the senior principals and actual experience in ARS is represented by proprietary trading, investment banking, academic study, and audit and control experience.

An absolute return strategy seeks not only to outperform a benchmark or index, but its goal is to always produce positive rates of return. Quellos’ approach to Absolute Return Strategies investment philosophy is four fold: a fundamental understanding of the investment manager’s strategy; aligning incentives between the management and the investor reduces the principal/agent conflict; exercising independent judgment in the selection of underlying hedge fund managers; and a belief that markets or macroeconomic instruments, such as foreign currencies, cannot effectively be timed. Quellos operates on the principle that a successfully run multi-manager investment program must demonstrate skill in four critical areas of the investment process: manager identification, manager evaluation, portfolio structuring, and risk management.

In it’s approach to ARS portfolio structuring, Quellos employs three disciplines: relative-value discipline, which seeks to profit from the mispricing of related financial instruments (formula related, statistically related, and fundamental spread trades); the event-driven discipline, which concentrates on companies that are, or may be, subject to corporate events such as restructurings, takeovers, mergers, liquidations, bankruptcies, or other special situations (distressed securities, mergers and acquisitions, and special situations); and the hedged-directional discipline, which involves buying and/or selling securities believed to be significantly under- or over-priced by the market in relation to their potential value (equity value and growth strategies, and long/short fixed income).

Director Wustenberg asked for the definition of a hedge fund. Collins advised that “for every hedge fund, there is a definition of a hedge fund.” In other words, there are many different styles and strategies, which tend to be cyclical in nature. But the majority of hedge funds practice a long-/short-termed equity that may concentrate on a specific geographic region, industrial sector, or both. Active equity investment management is predicated on the belief that portfolio managers can add value by selecting securities that will outperform a broadly diversified passive portfolio. Absolute Return Strategies employ this “value added” approach by specifically targeting market inefficiencies.

The ARS return differentials utilize annualized returns for offshore and domestic alternative investment vehicles (hedge funds) from October 1992 through September
2002. Funds with an inception later than October 1992 are included since their inception, but must have a minimum of at least 12 months of performance for inclusion.

Collins advised that Quellos’ database represents over 9,500 funds, and maintains a continuous proactive effort to identify new managers. Quellos’ network of professional investors significantly contributes to the discovery of new managers. Mr. Mueller, Oregon State Treasury, asked a question concerning the company’s turnover rate. Collins advised the company has 90 managers with a high degree of overlap and a 10 percent turnover per year.

Mike Green asked why a company wouldn’t put all of their money in hedge funds due to the high rate of return. Collins advised diversification is the key in a balanced portfolio. Most investment firms will place 5-10 percent of their portfolio in hedge funds; Quellos advocates for a 20-30 percent investment. Director Lehmann asked if it would make sense to be more heavily invested in Quellos when the economy is doing poorly? Collins replied that the biggest systemic risk is liquidity risk, since hedge funds are assuming liquidity risk. If liquidity dries up, it’s detrimental to hedge funds.

Collins indicated that the appreciation composite performance comparison between Quellos and the S&P 500 Index for the period 8/1995 through 7/2003 showed Quellos’ higher rate of performance over the S&P 500 Index:

<table>
<thead>
<tr>
<th></th>
<th>Quellos</th>
<th>S&amp;P 500 Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cumulative Return</td>
<td>181.8%</td>
<td>100.5%</td>
</tr>
<tr>
<td>Annualized Return</td>
<td>13.8%</td>
<td>9.1%</td>
</tr>
<tr>
<td>Annualized Standard Deviation</td>
<td>4.0%</td>
<td>17.0%</td>
</tr>
<tr>
<td>Sharpe Ratio</td>
<td>2.35</td>
<td>0.28</td>
</tr>
<tr>
<td>Correlation to the Composite</td>
<td>1.00</td>
<td>0.39</td>
</tr>
</tbody>
</table>

Collins advised that Quellos’ appreciation strategy is comprised of six multi-manager funds targeting annual returns of T-Bills plus 10 percent, with about half the long-term risk of the equity markets. The strategy seeks to neutralize the impact of the overall direction of the equity markets. The objective is pursued through the allocation of capital to external investment advisors pursuing a variety of Absolute Return Strategies.

In conclusion, Collins noted that since Absolute Return Strategies encompass a broad range of investment disciplines and strategies, investors using ARS are afforded the flexibility to target various risk and reward objectives. In order to limit risk, early identification of potential problems is essential. Quellos focuses on four areas of risk management encompassing both qualitative and quantitative disciplines: incentive structure (principals’ financial commitment and reinvestment of earnings), operational risk management (technology, asset safeguarding, portfolio pricing, and trade execution); performance risk management (single and multivariate analysis, peer group comparisons, and advanced statistical methods); and portfolio risk management (extensive data acquisition and scrubbing, dealing with complex and varied security types, sophisticated risk engines, valuable reporting, and portfolio transparency on over
80 percent of current managers). The aim of a performance risk manager is to identify unusual aspects of a manager’s record.

c. Real Estate

Ms. Beard introduced Laura Gaylord, partner, RREEF, and Frank Garcia, Portfolio Manager, RREEF America II, who joined the meeting via telephone. They provided a brief overview of RREEF and RREEF America II.

As background, Ms. Gaylord advised that RREEF is a full service real estate investment advisor. Five real estate practitioners founded RREEF in 1975 in order to give institutions access to the same hands-on real estate decision-making that private owners had enjoyed and been successful with for a long time. RREEF has been through a number of real estate cycles and understands dealing with adversity, as well as opportunity. RREEF’s assets have grown to $18.0 billion, and they have worked hard to preserve an entrepreneurial approach. Under direct RREEF management are 507 properties, encompassing all four major property types, with 159 million square feet.

A small team of 21 partners, located through the United States, still makes all investment decisions (portfolio management, acquisition, and disposition). These partners average over 21 years of real estate experience. RREEF currently employs 629 real estate professionals in the United States. Ms. Gaylord emphasized that one of the characteristics of RREEF that separates it from other companies is its strong and talented research group, with over 17 professionals dedicated to the research function and how that integrates into decision-making both on the private- and public-side. RREEF offers a diverse menu of investment options including: separate accounts, core and value-added private investment vehicles, and investments in publicly-traded real estate securities.

They have an extensive track record in the property reassignment business. RREEF has two primary goals: 1) preservation of capital and 2) to pay the highest possible dividend yield possible. RREEF invests in functional, leased properties (industrial, apartments, offices, and retail) in major metropolitan areas only, with added value through active, hands-on management.

Drawing on RREEF’s 28 years of experience as a direct investor, manager, and operator of U.S. real estate, RREEF Securities stresses the importance of real estate fundamentals in its approach to the analysis and selection of Real Estate Investment Trust (REIT) securities. Their investment philosophy is to maximize returns to clients by investing in a select number of real estate securities with strong cash flow growth potential and, therefore, the capacity for sustained dividend increases. They seek to uncover hidden value or earnings surprises by understanding the companies’ existing portfolios and potential to acquire or develop assets under attractive terms.
RREEF is very active in the Portland area, currently managing nine properties and 351 apartment units, which includes 5.7 million square feet and is worth $381.7 million. The Portland office is staffed by 13 employees.

Mr. Garcia advised that RREEF America II is privately held and structured to provide its shareholders with maximum control and flexibility of their investment positions. RREEF America II has an independent board of directors, elected by the shareholders. Shareholders vote to extend the life of the fund (with a finite life of 2015 on the fund). A three-quarters vote of the shareholders is needed to extend the life of the fund. Investors can enter/exit the fund on a quarterly basis.

RREEF America II currently has 106 institutional investors, with a total fund size of $1.7 billion growing to $3 billion-plus. The client profile is made up of 35 percent corporate pension plan, 29 percent Taft-Hartley, 25 percent public pension plan, and 11 percent endowment/foundation management. RREEF America consistently performs above its targeted returns in property and fund levels. The goal is for consistent returns with low volatility.

Similar to the original RREEF Fund, RREEF America II has two primary goals: 1) preservation of capital, to have appreciation and not lose capital value by buying institutional quality properties in a strong market that are going to appreciate over time; 2) to pay the highest possible dividend yields available. The annual investment plan is composed annually to outline the following year’s investment strategy. The RREEF Investment committee must approve this plan. When looking for the optimal locations for investment, the indicators for regional growth tend to be defense spending, international trade, high-tech manufacturing, and health and educational services.

Currently, 91 percent of their holdings are occupied, leases are in place that should bring the fund through the slow economic times. Because of the types of property bought, there are limited capital expenditures (1.5 percent budgeted). There is a very good tenant base as far as credit, with little exposure to bankruptcies over the past five years. RREEF America II continues a dividend yield of between 6 to 8 percent. Ms. Beard asked if 91 percent occupancy is high or low. For most funds overall, 91 percent occupancy rate is good; however, they would like to see the percentage increase to 94 to 95 percent.

Director Wustenberg asked if the company is involved in new construction or if they only buy buildings already in existence. Garcia advised the fund is fairly conservative, and would associate buying land for development as having higher risk more aligned with a value-added fund. RREEF America is not allowed, per their investment plan, to invest in development properties; instead, they buy properties that are fully leased, and are existing properties with a good track record.

RREEF does, in limited instances, buy property in need of renovation (apartment complexes located on prime locations) and as the tenants move out, renovate the exterior and interior of the apartments. Upon renovation, the apartments then receive
higher market rents on those units. On occasion, vacant buildings are purchased, renovated, and then leased. This type of activity cannot exceed 10 percent of the value of the fund.

In conclusion, Mr. Garcia gave several reasons for investing in RREEF America II: the private REIT structure and that, as a private REIT (tax-exempt status at the corporate level), they are compelled to keep that status by paying out 90 percent of their taxable refund back to their investors; investor control and liquidity; a dedicated portfolio management team; buying properties at cost, not inflated values; overweighting apartments and industrial and tri-coastal markets to outperform NCREIF (Nat'l Council of Real Estate Investment Fiduciaries) over the next three years; and the excellent RREEF property management.

Mr. Mueller asked what the benefits to an investor of a private REIT over a publicly traded REIT would be. Garcia agreed that on the liquidity there is more liquidity on the public-REIT side, but there is also more volatility involved and is somewhat at the mercy of the capital market. Ms. Gaylord added that on the public side, you would be buying into an operating company, whereas on the private side, you are buying into the actual real estate—owning a piece of that real estate.

Following the briefing from RREEF, Ms. Beard advised that there are different types of real estate, this is core real estate, not speculative. So, their goal is to provide income—they certainly don’t want to lose money on a property, but to ensure some appreciation. She speculated that, in dollars, they would tell you that they are looking for more 80 percent income, 20 percent appreciation, to be on the conservative side. Wustenberg noted that RREEF has taken a lot of the speculation away by knowing what the income is before investing.

d. International Value Search

Ms. Beard noted that T. Rowe Price has become more of a growth manager in the international markets. So, the decision at the July 2003 meeting of the Committee was to research adding a value manager to keep style neutrality in the international equity allocation.

OUS has a current allocation policy of 10 percent to international equity. A change would shift some monies from T. Rowe Price to three other international managers (Causeway Capital Management LLC, Mercator Asset Management, LP, and Templeton/FTI Institutional). We have included these three managers because they currently are the top three value managers. Templeton’s performance has been convincingly very good. The other two firms have shorter track records but we have seen these before. For example, Causeway Capital Management started out as another international values company. Mercator is a Templeton group that has moved from Fort Lauderdale to Boca Raton.
Following interviews recently conducted, they seem to be evenly split between the selection of Mercator or Causeway. They are all bottom-up stocks, and not index funds. The firms do things a little bit differently—Causeway definitely focuses on yield, but they also look at the price. As far as diversification, Mercator focuses on less security than the other two. Templeton currently has smaller margin caps. All three have low turnover-rate portfolios.

Director Wustenberg asked if T. Rowe Price has changed their strategy. Beard answered that she doesn’t know if they’ve changed their strategy, they’re just admitting they’re no longer core strategy. It is probably fair to say that it’s benchmarking them against a growth index.

Mr. Mueller advised that we’ve only recently, this year, made that differentiation of the pension fund between value and growth on the international side. Usually, we just split it between developed markets and emerging. Wustenberg asked if OUS wants to be half value and half growth? Beard affirmed that. Wustenberg asked which company Beard would recommend to the Committee. She replied that any of the three would suit the needs of OUS. She would lean toward Mercator and Causeway over Templeton because they are younger, newer firms, and people tend to leave Templeton to go start their own companies. Templeton tends to be a good training field for people.

Wustenberg asked what would be the next steps for the Committee to take—interview the companies? Beard and Green agreed. Mueller recommended selling half of the 10 percent allocation to T. Rowe Price and transferring the proceeds to Mercator or Causeway.

Chair Wustenberg advised Beard and Green that, unless there is a compelling reason to not interview one or the other or if they gain information about which would be preferable, then go ahead and interview the companies. Beard recommended interviewing both companies, either face-to-face or by telephone. It was asked if Templeton would not be interviewed. Beard stated that, based on their performance on a year-by-year basis, Templeton falls short of the other two firms. Mercator and Causeway tend to be a bit more consistent in their returns than Templeton.

It was recommended that the Chancellor’s Office staff arrange the telephonic interviews in the near future.

e. Asset Allocation

The asset allocation study for the Oregon University System is a reminder of why it was important to look at absolute return and real estate. R.V. Kuhns does not use strictly historical returns for their expectations for return. So, given the expectations, they have not changed in the past two months. Using the asset classes that OUS currently has, the OUS target portfolio and current portfolio were plotted against the Efficient Frontier. This plotting indicates that the investment has been aggressive, with 70 percent in equity and, given the asset factors used, OUS is on the Efficient Frontier.
The only way to increase the return is to take on additional risk. The expected return for the target portfolio is 7.69 percent, with a one-year standard deviation of 11.36 percent. Obviously, with more years to invest, that standard deviation reduces, so over a three-year period, the likelihood of a three-year annualized negative return is not likely.

A spreadsheet was provided demonstrating what the results would be if the Efficient Portfolios model applied the full 10 percent, the maximum allowed, into additional two asset classes (which includes current assets, real estate, absolute return, and private equity). Given that the standard deviation is 11.36, by adding these two asset classes, a higher return is achieved at a lower risk. This is on a long-term strategy, rather than the short-term. Director Wustenberg asked if OUS would be allowed to apply the 10 percent into these asset classes. Because the current investment policy does not allow investment in hedge funds, Green advised that, at this time, OUS would not be allowed by the state to apply the full 10 percent. Beard agreed and added that the policies would have to be changed in order for this to be accomplished. Mueller advised that, with the concurrence of the Oregon Investment Council (OIC), up to 10 percent of the aggregate funds can be invested in venture capital, real estate distressed, and oil and gas. As background of where the OIC is coming from, it is understood that it can pertain to endowments and pension funds but historically there is no allocation to hedge funds for ORPER. (the Oregon pension fund). Although the State Treasury has a 10 percent allocation in private equity, none of that is hedge funds right now. Mueller asked the question “why the private vs. the public groups? If you want to take a foray into real estate, why not do it with small REIT exposure?” Beard stated that Kuhns' answer would be the return would have to be completely changed due to the risk assumption, because they are stocks and tend to be affected by the stock market with greater volatility.

Mr. Mueller agreed to investigate how the OIC would feel about OUS changing its investment policy to allow investment in hedge funds such as the absolute return strategy. Staff will coordinate schedules to set up a phone conference to interview Mercator and Causeway.

4. **ADJOURNMENT:**
The meeting adjourned at 2:45 p.m.