

MINUTES OF SPECIAL MEETING OF
THE BOARD OF DIRECTORS OF
THE UNIVERSITY OF TEXAS
INVESTMENT MANAGEMENT COMPANY

The Board of Directors of The University of Texas Investment Management Company (the "Corporation") convened in special meeting on the 17th day of April, 1996, in the First Floor Conference Room, 210 West 6th Street, Austin, Texas, said meeting having been called by the Chairman, with notice provided to each Director in accordance with the Bylaws. Participating in the meeting were the following members of the Board of Directors:

Thomas O. Hicks, Chairman
Robert H. Allen
R.D. Burck
Susan M. Byrne
William H. Cunningham
Arthur H. Dilly
Donald L. Evans
Richard W. Fisher
Tom Loeffler

thus, constituting a majority and quorum of the Board of Directors. Also, participating in the meeting was Bernard Rapoport, Chairman of the Board of Regents of The University of Texas System (the "System"); Thomas G. Ricks, President of the Corporation; Jerry E. Turner, Secretary of the Corporation; J. Luther King, Jr.; Debbie Mitchell and Randy Reid of the State Auditors' Office; and Robert Holland, Russ Kampfe, Cathy Iberg, Austin Long and Craig Nickels of Corporation management. Mr. Hicks called the meeting to order at 8:00 a.m.

Approval of Minutes

The first matter to come before the Board of Directors was approval of the minutes of the special meeting of the Board of Directors held on February 22, 1996, copies of which had previously been furnished to each Director. By motion duly made, seconded and carried by a unanimous vote, the Board of Directors duly approved the minutes of such meeting.

Funds Summary

Mr. Ricks presented an overview of the assets under management by the Corporation. He stated that it was important to understand that the management of the fixed income, equity and private investment portfolios is overlaid by distinct fund groups, the structure of which is presented under Tab 2 of the presentation materials. Under the investment management services agreement with the U.T. Board of Regents, the Corporation is responsible for the investment management of five fund groups aggregating approximately \$9 billion in market value, including the Permanent University Fund (\$5.28 billion) managed by the Corporation on behalf of the System and the A&M System as income beneficiaries.

The remaining \$3.7 billion of funds are managed by the Corporation for the sole benefit of the System in the form of internal mutual funds and separately managed funds. Each mutual fund has a different risk/return profile and time horizon. The Long Term Fund (\$1.7 billion) has a very long term investment horizon befitting the 4,000 endowments underlying the fund. The Short/Intermediate Term Fund (\$1.3 billion) has a duration of roughly two years and is designed to match the maturity of reserve and other funds not consumed in the operating cycles of the fifteen component institutions that comprise the System. The Short Term Fund (\$594 million) is an external money market fund which provides overnight liquidity and stability of value for component operating funds. Finally, the separately invested funds (\$170 million) are endowments and trusts where the donor or legal terms preclude pooling.

Mr. Ricks stated that the funds in aggregate have grown substantially over the 4.5 year period since fiscal year end 1991. Despite this absolute asset growth, performance of the longer term funds lagged the total returns generated by other endowment funds. This underperformance was almost all attributable to income payout policies and the resulting high allocations to fixed income.

Mr. Ricks also stated that with the adoption of the Uniform Management of Institutional Funds Act by the Texas Legislature and the ability to pay out realized gains, the LTF asset allocation has been shifted to 70% equities and 30% fixed income over the past year and a half. The PUF is still approximately 50/50 resulting in a divergence in performance over the last year.

Mr. Ricks stated that it was also important to note that despite the designation of equities as the dominant asset class for the endowment funds, the Corporation is still very much dedicated to the management of fixed income portfolios. This is due not only to the management of long term bond portfolios for the endowment funds, but to the management of \$1.8 billion of short and intermediate term portfolios in support of the health and academic operations of the System. Fixed income assets which are represented across every fund group at \$4.9 billion comprise 55% of total investment assets. Equities and private investments which are endowment-only activities at \$3.6 billion and \$395 million, respectively, constitute 40% and 4% of total assets, respectively.

Quarterly Investment Review

Fixed Income:

Background

Originally, System component institutions invested their operating funds locally. Consequently, investment of fixed income portfolios was confined to the PUF and LTF. Investment strategy for these long term bond portfolios was and in the case of the PUF continues to be dictated by legal restrictions. The Constitution, using antiquated trust law concepts, requires the payout of all income and prohibits the reinvestment of income. Conversely, it requires the reinvestment of all gains and prohibits the payout of any gains. As a result, total return based strategies, such as a rate anticipation strategy, where income and price appreciation are viewed as a whole, are inapplicable for the PUF where income and price return are separated. The response to these restrictions has been the use of a buy and hold strategy to reduce volatility of income. In addition, under payout policies adopted

by the U.T. Board, emphasis has been on maximization of income versus replication and growth in income.

The prohibition on total return strategies for the PUF continues to be a major problem. As income beneficiaries only, the System and the A&M System have emphasized the generation of maximum current income in order to maximize debt service capacity for PUF bonds and to payout to their respective flagship universities. Maximization of yield has meant investment in higher yielding fixed income securities. Since coupons by definition were fixed, income growth was to come from oil and gas royalties on PUF lands. Once a major contributor to PUF income, the royalty income has diminished in importance to where income growth must now come from dividend growth of equities. Without a total return based spending rate, stability and growth of PUF income is unmanageable. This was particularly true in recent years when income on the bond portfolio was declining and runoff at 9%-10% was being reinvested at a 6.5% coupon. Without the ability to pay out realized gains, income cannot be controlled throughout the interest rate cycle.

Dr. Cunningham stated that a change in the calculation of PUF spendable income would require a constitutional amendment - a politically risky action given constitutional designation of the System and the A&M System as sole income beneficiaries. At the same time, with the PUF financing program frozen, certain component institutions viewed membership in the PUF financing program as inferior to HEAF funding. Mr. Hicks requested and the Board of Directors concurred that Mr. Ricks prepare a "white paper" analyzing the impact of the constitutional restrictions of the PUF for submittal to the Board of Directors at its next meeting.

Mr. Ricks then remarked that the LTF was converted to a total return basis in 1995, thus allowing for use of total return fixed income strategies. This was timely in that after a four year freeze in the payout formula, payout now exceeded income. Under new total return allocations approved for the LTF, bonds have been reduced to 20% of total assets. The role of the fixed income portfolio has been redefined to that of deflation hedge - insuring a minimum income return during a recessionary or depression environment. This means that the portfolios will emphasize non-callable high quality bonds. In addition, 25% of the current bond portfolio will be allocated to high quality foreign bonds for diversification purposes. The end result is that no new funds are being allocated to the long term bond portfolios for the LTF and PUF in order to rebalance assets and grow payout.

Mr. Hicks stated that he believed it was appropriate for the Board of Directors to review all fund investment policies including the asset allocations at least annually. Mr. Ricks mentioned that the investment policies currently in effect had been transferred intact with minor modifications to reflect the transfer of management to the Corporation. The exception was the PUF policy which had been reviewed by the Asset Management Committee of the U.T. Board and which had been approved by the U.T. Board simultaneously with the approval of the management contract with the Corporation. He opined that review of the PUF investment policy should follow review of the "white paper" by the Board of Directors. However, the LTF allocation was significantly different than that of the PUF. Mr. Evans offered that examination by an external consultant might be merited. Mr. Ricks responded that the LTF allocation was based on optimization analysis performed by Cambridge Associates. The Board agreed that Cambridge Associates should be invited to make a presentation at the August meeting to present its analysis.

Mr. Ricks stated that it was important prior to establishing asset allocation to arrive at a consensus on the tolerance for risk. Asset allocation was the process of combining asset classes to maximize the expected return for a specified level of risk.

Management of short term investments was centralized at the System in 1988. At that time, the majority of component institutions were mostly invested in local bank deposits and U.S. Treasuries earning below market yields. Subsequently, in 1993 the S/ITF was established as an internally managed mutual fund to provide higher yields for component funds.

Almost 90% of the fixed income portfolios is managed internally at a very low cost. The fixed income portfolios for the endowment funds were a single portfolio managed by a single manager. The fixed income group was a two person staff led by Mr. Robert Holland, Vice President with responsibility for the long term maturities and Mr. Russ Kampfe with responsibility for short and intermediate term maturities.

Permanent University Fund

Mr. Ricks then asked Mr. Holland to present fixed income activity for the quarter ended 2/29/96. Mr. Holland reviewed certain characteristics of the portfolio, particularly the "run-off" schedule and the average quality rating.

He apprised the Board of Directors that in recent years the PUF portfolio has essentially been managed to a maturity schedule, avoiding mortgage-backed securities and, to the extent possible, callable bonds. The objective was to "ladder" bond maturities so that not less than 2½% or more than 4% of the portfolio will mature each year out to 30 years. This was to minimize reinvestment risk and thus assure a more dependable income stream. While progress has been made in filling holes in the maturity ladder, the structure of new bond issuance makes it increasingly impractical to limit holdings in certain out years to the desired maximum of 4% of the portfolio. It was requested that the Board of Directors grant flexibility in the achievement of this 4% maximum figure, realizing that over time there will almost certainly be opportunities to better balance the maturity schedule.

A discussion then ensued concerning the authority of the Board of Directors to provide the requested flexibility. Mr. Ricks stated that the PUF investment policy approved by the U.T. Board did not contain any language to ladder the portfolio; rather, this was a strategy to achieve the investment objective of providing a stable and predicable income stream which was a policy objective. The Asset Management Committee of the U.T. Board was aware of the strategy as the schedule of maturities was presented at each meeting. Dr. Cunningham suggested that Mr. Ricks make a presentation concerning the delegations of authority from the U.T. Board to the Corporation's Board of Directors and in turn to the Corporation's staff. Mr. Evans strongly supported this suggestion stating that complying with legal and contractual conditions by the Corporation was critical.

Mr. Holland also pointed out that while the average quality rating of the PUF bond portfolio is currently "Aa2", it will be difficult to maintain this rating for the following reasons: (a) the "Aaa" mortgage sector of the portfolio is running off with proceeds being reinvested in "A" rated corporates in order to retain as much yield as possible, and (b) the significant holding in electric

utility bonds is now more subject to down grade due to deregulation in that industry. Mr. Fisher inquired as to whether policy allowed for the purchase of below investment grade bonds. Mr. Holland responded that the PUF policy did not, however, there was no requirement to sell a bond which falls below investment grade after date of purchase. Mr. Hicks then inquired if there should be a program to invest in high yield or distressed securities. Mr. Holland replied that the Corporation's in-house staff is too thinly staffed and has no analytical training for such a specialized sector. Mr. Ricks added that the Asset Management Committee of the U.T. Board has approved a 10% allocation from the LTF to invest in publicly traded alternative assets which included high-yield bonds. However, the asset class was unfunded as the staff was concentrating on diversifying into international and emerging market equity asset classes first.

Long Term Fund

(No presentation of the Long Term Fund fixed income portfolio occurred because of time constraints.)

Short/Intermediate Term Fund

Mr. Ricks then asked Mr. Kampfe to review activity in the \$1.2 billion S/ITF. Mr. Kampfe reviewed the S/ITF second quarter summary for the Board of Directors. He noted the fund's slightly bullish outlook for the months ahead, particularly due to yields reaching their highest levels over the past 9-12 months. He indicated that if the market showed some ability to stabilize at the current higher yields, the fund would become significantly more bullish with significant purchases of securities in the 3-5 year maturity area. The most significant change in S/ITF assets for the second quarter was a \$124.2 million net contribution by fund participants. The only question concerning this was from Mr. Fisher who asked if the staff understood how to account for CMOs. Mr. Kampfe responded that the staff had been investing in CMOs for over ten years and were confident of their understanding. Mr. Kampfe concluded by reviewing the fund's summary and holdings.

Short Term Fund

Mr. Ricks reported that the only external fixed income management was in the management of short term funds. Goldman Sachs Asset Management was engaged in 1988 to manage the \$600 million Short Term Fund. The original fee was 30 basis points which was renegotiated down in 1993 to 18 basis points. With the formation of the S/ITF Fidelity was hired to manage the approximately \$100 million liquidity portion of the fund also for 18 basis points.

Ms. Byrne remarked that she believed an 18 basis point fee for short term, fixed income management appeared high. Mr. Ricks replied that the fee included custody and, in the case of Goldman Sachs, use of the Goldman Sachs trading and reporting system by each of the component institutions. Management's review had indicated that the major money funds all charged 18-20 basis points. The money fund structure and the prohibition against "preferential dividends" effectively "precluded" the funds from providing fee discounts to larger customers. As a result, the question was whether management could invest the short term funds for less than the \$1.25 million currently paid on an annual basis. This issue was to be examined by the staff following completion of the custodian

consolidation process at the end of the fiscal year. The Board of Directors agreed as a group that Mr. Ricks should express his concern over the fee and ask the firm what they might offer in terms of a fee reduction.

Equities:

Background

Mr. Ricks reported that prior to 1985, the equity portfolio was 100% actively and internally managed as a single U.S. large cap portfolio. In 1985, following the formation of the System's Office of Asset Management, 30% of the asset class was allocated to seven external managers. In 1993, following Mr. Ricks's appointment as chief investment officer, the equity asset class was restructured to increase diversification. Approximately 50% of the asset class was indexed through Wells Fargo/Nikko. The balance was actively managed through two internally managed portfolios (20%) and with external managers (30%). Mr. Ricks stated that the majority of the external managers were terminated as part of the restructuring. In addition, a minority manager program was established and overall portfolio management expenses were reduced by 25%.

Mr. Ricks also stated that a major objective was to evaluate the current equity management program in light of the new asset allocation program for the LTF and the excessive number of managers brought on since 1993. He wanted to first recruit a Vice President - Equities in order to assist in the process. In response to questions regarding compensation, Mr. Ricks responded that his market research indicated that he could expect to pay \$150,000 plus a 25% bonus. This would be a critical recruitment as equities would be the growth vehicle in the future.

U.S. Domestic Equities

Presentation by Austin Calvert & Flavin

Representatives of the firm reviewed their investment style for the \$114 million combined equity portfolios which they characterized as relative value with a growth bias. The firm uses a top down approach to assess the market environment and a bottom up approach to research potential stocks. The firm evaluates equities on both absolute and relative measures and attempts to fit them to a model portfolio. The firm then presented its overview of the stock market, expressing concern about current valuations and making comparisons versus the Japanese stock market prior to its major correction. The firm stated that it would like the flexibility to hold more cash but would abide by Mr. Ricks's instructions to keep cash at minimum levels.

Presentation by Kemper Capital Management

Representatives of the firm stated that their objective was to create real returns and to achieve long term returns by conserving principal. It concentrated on overlooked stocks paying high yields. In particular, stocks of companies with high cash flows but where the whole industry or the company may be depressed for the wrong reasons. Since they don't buy stocks that don't conform to their discipline, they will build cash in up markets which was the reverse of most institutional investors. As a result, they will achieve most of their returns in up markets but not runaway markets. The firm pointed out that the System portfolios had not seen a downturn. Mr. Allen inquired about the firm's cash level which was reported to be at 30%.

Emerging Markets

Mr. Ricks reported that the LTF asset allocation program contained a 3% allocation to emerging markets. The staff had delayed funding the allocation until it believed the timing was appropriate for funding. The staff had proposed funding at the last meeting when the Board of Directors approved funding at the 1.5% level or approximately \$20 million with Templeton Investment Counsel. The Board of Directors had deferred funding the remaining 1.5% in order to obtain the input of the new directors. Mr. Ricks reported that due to new contributions and appreciation, the 3% allocation now represented \$50.8 million for an incremental funding requirement of \$30 million. He reviewed an updated comparison of the return and risk performance for the original five finalists and recommended that the balance of the funding be committed to Templeton. The general consensus of the Board of Directors was that diversification away from the U.S. equity markets made sense and that the current level of 1.5% did not represent a sufficient exposure to the asset class to impact returns.

By motion duly made, seconded and carried by a unanimous vote, the Board of Directors approved the full funding for the 3% emerging markets allocation.

Private Investments:

Thayer Equity Investors III, L.P.

The Thayer principals (Fred Malek, Paul Stern and Rick Rickertsen) made a brief presentation, citing their individual credentials and accomplishments and discussing their proposed investment strategy (all of which are contained in the staff's Thayer Equity Investors III, L.P. Due Diligence Review and Recommendation).

During the presentation, Mr. Allen expressed reservations as to the achievability of the principals' quantitative measure of partnership value added: a 25% or more improvement in cash flow for each portfolio investment in its first year. Mr. Malek, citing hotels in general and Ritz-Carlton in particular, stated that increases in cash flow of this magnitude are possible but conceded that some businesses cannot be expected to produce that result in such a short time period.

After the presentation, Mr. Evans asked the principals their response to a particular hypothetical transaction, with a purchase price of \$300 million to \$500 million, requiring \$75 million in equity. The principals replied that they see similar transactions in the current market and cite CB Commercial and Ritz-Carlton as two such successful transactions in their track record.

Mr. Hicks asked the principals whether they can work together for a prolonged period. Mr. Stern replied that his long friendship with Mr. Malek, the stresses of fundraising over the past year and the fact that their spouses are friends all point toward long-term compatibility.

Mr. Hicks asked what the Thayer Capital's partnership governance procedures are, particularly with regard to investment decision making. Mr. Malek replied that all three Thayer Capital principals are equal partners and each investment required unanimous approval of the partners.

The Thayer principals then left the meeting room and the Board of Directors discussed the merits of the investment. The staff, in summarizing the investment prior to the discussion, emphasized the level of experience and ability of both Mr. Malek and Mr. Stern and stated that Mr. Rickertsen's involvement was likely to mitigate any friction which might be expected to develop between the other two partners.

Mr. Fisher stated that in his opinion the partnership could be short-lived. Mr. Hicks agreed with the staff that the Thayer principals could produce attractive returns in the current partnership but also agreed with Mr. Fisher that it was unlikely they would stay together long enough to raise and invest a second partnership.

After a short further discussion of the Corporation's policy on partnership continuity, the Board of Directors, by motion duly made, seconded and carried by a unanimous vote, approved a commitment of \$20 million subject to further due diligence prior to closing. In voting affirmatively, Mr. Fisher expressed reservations as to whether the Thayer principals could maintain their partnership over more than one fund.

(Note: as a result of further due-diligence, the indicative commitment of \$20 million was withdrawn in favor of observing the general partners' performance in the fund over the next three years.)

At this point in time, Mr. Allen left the meeting.

Wand Equity Portfolio II, L.P.

Prior to the presentation, Mr. Hicks recused himself from consideration of Wand, citing his 32 year history with its principals, including certain co-investment transactions and co-advisory business relationships. As discussed in the Due Diligence Review and Recommendation booklet provided to the Board of Directors, the Corporation staff has determined that Mr. Hicks has no prohibited financial interest in the Wand Equity Portfolio II, L.P. within the meaning of Section 66.08 of the Texas Education Code.

The Wand principals (Bruce Schnitzer and David Callard) then made a brief presentation, citing their individual credentials and accomplishments and discussing their proposed investment strategy (all of which are contained in the staff's Wand Equity Portfolio II, L.P. Due Diligence Review and Recommendation).

The Wand principals then left the board room and the Board of Directors discussed the merits of the investment. The staff, in summarizing the investment prior to the discussion, emphasized the value remaining in the initial Wand fund's software and business services investments, which should result in superior returns at the point they are eventually realized. The staff noted that investing with the Wand principals over the next 18 months or so is an interim step on a partnership by partnership (i.e., investment by investment) basis, to be followed by the raising of a conventional fund in which the staff would proposed to participate. The staff also noted that the relationship between the Wand principals and the staff is expected to be unusually close, with Wand serving to introduce the staff to a number of co-investment opportunities on an unpromoted basis.

The staff outlined certain key items on the term sheet not yet agreed to by the parties and proposed the following position on each: all interim investments prior to the raising of the fund should be aggregated for purposes of determining payback; the request of the Wand principals to vary the amounts invested by the general partners for each investment amounts to cherrypicking and should be denied in favor of a fixed ratio; the Wand proposal to share only 25% of transaction fees with the limited partners is at the low end of the acceptable range and should be negotiated up; and the terms under which each of the partnerships can be extended should be altered to require a vote of the limited partners. Finally, the staff proposed imposing the same promoted interest hurdle rate for Wand II as for the staff's incentive compensation program: 500 basis points over the S&P 500 on a dollar-weighted, time-weighted basis.

After some discussion of the staff's proposed promoted interest hurdle rate computation, the Board of Directors, by motion duly made, seconded and carried by a unanimous vote (Mr. Hicks abstaining), unanimously approved a commitment of up to 20% of the club/fund amount representing \$13.125 million initially and then up to \$30 million assuming an ultimate fund size of \$150 million. Mr. Evans summarized the particular concerns of the Board of Directors in approving this investment: that the Wand agreement should prohibit cherrypicking on the part of the principals investing as general partners; that all investments should be aggregated for purposes of determining payback; and that the computation of the promoted interest be done on the most advantageous terms to the System's interest as possible.

Financial Report - March 1996

Mr. Ricks then presented the Corporation's balance sheet (unaudited) as of March 31, 1996, the Corporation's statement of revenue, expenses and changes in fund balance (unaudited) for the period of March 1, 1996 through March 31, 1996, and the Corporation's statement of cash flows (unaudited) for the period March 1, 1996 through March 31, 1996. He stated that there was nothing to report concerning the Corporation's first month of operations as operations had proceeded as expected.

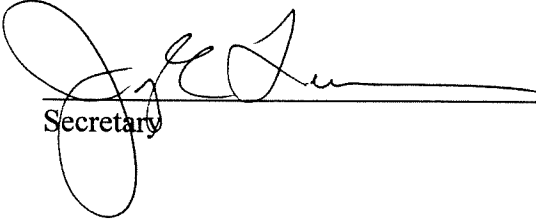
Fiscal Year 1996-97 Budget Parameters

Mr. Ricks stated that the System, as part of its budget planning for fiscal year 1996-97, had requested the amount of investment management fees to be charged beginning September 1, 1996. Mr. Ricks added that this was difficult given the Corporation's existence for one month. Given the need for a number, he had submitted a 5% increase over the annualized fee amount for the second half of fiscal year 1996. The Board of Directors indicated that these budget parameters were acceptable. Mr. Ricks stated that a detailed budget would be submitted for approval at the August meeting.

Meeting Date

Mr. Ricks stated that the next meeting dates needed to be scheduled. He was instructed to telephone directors for mutually convenient dates for the remainder of the calendar year.

There being no further business to come before the Board of Directors, the meeting was adjourned.


Secretary

APPROVED:

