

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 10th day of June, 1996, in the offices of Hicks, Muse, Tate & Furst Incorporated, 200 Crescent Court, Suite 1600, Dallas, 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  
Susan M. Byrne  
William H. Cunningham  
Donald L. Evans  
Richard W. Fisher  
J. Luther King, Jr.  
Tom Loeffler  
Homer L. Luther, Jr.

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; and Cathy Iberg, Austin Long and Craig Nickels of Corporation management. Mr. Hicks called the meeting to order at 1:15 p.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 April 17, 1996, copies of which had previously been furnished to each Director. Mr. Ricks discussed certain editorial revisions to the minutes that were recommended by Mr. Turner, including an elaboration as to Mr. Hicks' recusal from participation in the discussion and approval of the Wand Equity Portfolio II, L.P. investment. Mr. Rick's indicated that the revised minutes would be presented to the Board of Directors for approval at its next meeting.

**UTIMCO Governance and Compliance Process**

Mr. Turner, as counsel to the Corporation, presented an overview of the standards of conduct applicable to the Board of Directors pursuant to the Texas Non-Profit Corporation Act. Mr. Turner advised that the Directors are required to act in good faith, with the care a prudent person in a like position would exercise under similar circumstances, and in a manner they reasonably believe to be in the best interests of the Corporation. Mr. Turner also described certain statutory immunities from liability and indemnification arrangements afforded the Directors.

Mr. Ricks then distributed a handout (also distributed at the June 10, 1996 Audit & Ethics Committee meeting) outlining the different statutes, agreements, policies and Codes of Ethics with which the Corporation was obligated to comply. Compliance by the Corporation was required in five major areas: federal statutes; state statutes; the Investment Management Services Agreement; investment policies; and the UTIMCO Code of Ethics. Compliance regarding certain federal and state tax issues involved compliance with Internal Revenue Code Section 501(c)(3).

Mr. Ricks also reviewed statutory requirements under state statutes. He reviewed the major requirements of Section 66.08 of the Texas Education Code, Article VII, Section 11b of the State Constitution governing investment of the PUF, Chapter 51 of the Texas Education Code and, finally, Section 163 of the Texas Property Code. Mr. Ricks also reviewed the duties required of the Corporation under the Investment Management Services Agreement noting that the investment policies were to be presented for annual approval by the Board of Regents of the System (the "U. T. Board"). Mr. Ricks also stated that the review of the PUF and LTF policies by the Board of Directors was scheduled to begin at the next meeting when Cambridge Associates would update its asset allocation study for the LTF.

Mr. Ricks also briefed the Board of Directors on the need to comply with the UTIMCO Code of Ethics. He also stated that the UTIMCO Financial Disclosure and Conflict of Interest Statement which was signed by Corporation management would be circulated to the Board of Directors as discussed in the Audit & Ethics Committee meeting.

Finally, Mr. Ricks stated that a formal compliance statement would be generated each quarter and submitted to the Board of Directors. There were no questions from the Board of Directors concerning compliance matters.

### **1997 Legislative Issues - Amendment of Constitution**

Mr. Ricks then referred to Tab 3 of the meeting booklet stating that the staff had identified four statutory or constitutional issues where amendment would enhance the effectiveness of investment management.

The first statute was Subsections 66.08 (i) - (j) of the Texas Education Code. Subsection (i) prohibits the Corporation from entering into an agreement with a former Director, officer, or employee of the Corporation before the second anniversary of the date the person ceased to be a Director, officer or employee of the Corporation. The Corporation is also prohibited from entering into an agreement with a business entity in which a former Director, officer or employee of the Corporation has an interest on or before the second anniversary of the date the person ceased to be a Director, officer or employee of the Corporation. Mr. Ricks stated that this restriction was stronger than the conflict of interest standards which were currently applicable to the System. "Interest" was defined to include money received by the person from the business entity which exceeded five percent of the person's gross income for the preceding calendar year. Mr. Ricks stated that this definition of "interest" effectively eliminated a current or prospective Corporation employee's employability with the large number of financial institutions with which the Corporation had a relationship. It also had the unintended effect of voiding the Corporation's contracts with an existing financial institution. Few recruits would consider working for the

Corporation under such circumstances. There was general agreement that this provision should be softened.

Mr. Ricks also stated that Corporation management was in discussion with the State Comptroller's Office and State Treasurer's Office to solicit their endorsement for amendments to Sections 66.02 , 66.07 and 66.78 of the Texas Education Code. Mr. Ricks characterized these provisions as operationally inefficient and reflective of outdated investment procedures. The Board of Directors requested that Mr. Ricks inform them of progress on this issue.

Mr. Ricks then referred to the Analysis and Proposed Amendment to the Texas Constitution for the PUF which he had distributed earlier to the Board of Directors. This document discussed a proposal to amend the Constitution to convert the PUF's current income only spending formula to a formula based on long term equilibrium concepts. Such an amendment in Mr. Ricks' opinion would improve the probability of the PUF's being able to preserve the purchasing power of both the spending stream and the fund value after withdrawals for spending. A discussion ensued among Directors discussing the pros and cons of the proposed amendment. The discussion concluded with a general agreement that the Board of Directors would not support the proposed constitutional amendment at this time. The Board encouraged Mr. Ricks to continue the dividend growth strategy that was currently in place as well as the gradual conversion to a higher equity content for the PUF.

### **Review of Investment Performance**

Mr. Ricks then reviewed investment performance for the most recent month, quarter and fiscal year to date. He stated that year to date the increase in the equity allocation to 70% for the LTF had paid off resulting in an 11.3% unannualized total return versus 9.8% for the PUF. The divergence in the most recent quarter and month had widened as fixed income securities had posted negative returns. He also stated that the increased diversification of the LTF into small cap growth had paid off as well since this was the best performing sector for the year. His expectation was that LTF performance for the year would be considerably more in line with the mean return of the Cambridge Associates universe.

### **LTF Risk Management - Value at Risk**

Mr. Ricks reported that the Board of Directors would soon begin the process of reviewing investment policies. Since asset allocation was a fundamental aspect of investment policy, it was important to bear in mind that asset allocation was derived from a stated risk tolerance and the optimal combination of asset classes to maximize return for a given level of risk. He referred to the efficient frontier analysis performed by Cambridge Associates for the LTF stating that prior to restructuring of the asset allocation in place had an expected arithmetic average return of 6.7% and an expected risk (standard deviation) of 13.1% for a return/risk ratio of .51:1. In adopting the new asset allocation, the Board of Directors had increased its risk tolerance as measured by the standard deviation of the return to 14.3%. At the same time, the asset allocation had resulted in a proportionately greater increase in expected average return to 8.8% each year as measured by the higher efficiency of the portfolio. This was evidenced by a higher return/risk ratio of .62:1.

Mr. Ricks also reported that management had commissioned Bankers Trust Company to perform a value at risk study of the LTF using a proprietary model known as RAROC ("Risk Adjusted Return on Capital") to determine risk on an absolute dollar basis. The model decomposed each portfolio security into a multitude of currency, interest rate, option, and other risk components to predict the maximum cumulative loss that the fund could incur over the next year with a 99% confidence level. The analysis predicted that the maximum cumulative loss that could occur through February, 1997 was \$271 million or 16.6% of the current market value of the fund. The analysis also revealed that virtually all of the risk reduction in the fund was being generated by asset allocation. Mr. Ricks stated that Bankers Trust Company was using only three years of historical data in the RAROC model. , Mr. Ricks was trying to compare the projected risk level implied by RAROC. The RAROC analysis implied there was less expected risk in the fund versus the original Cambridge Associates analysis, however, it was important to note that the RAROC analysis was completed in the midst of the restructuring to the new asset allocation recommended by Cambridge Associates..

Mr. Evans requested that a separate report be presented to the Board of Directors regarding current asset allocation versus the target allocations. Mr. Ricks responded that current allocation was reported in an exploded format in the quarterly investment report. He agreed to highlight asset allocation at the beginning of each meeting.

### **Consideration of Divestiture of Tobacco Holdings**

The next item to be discussed was consideration of divestiture of tobacco stocks. Mr. Ricks reported that across the PUF and LTF, tobacco holdings were \$66.3 million or 1% of assets. Approximately 70% of the holdings were represented by Philip Morris of which 75% was held by active managers and 25% in index funds. Another 25% was in the form of holdings in U.S. Tobacco which was held in an internal active portfolio. The balance or 5% was held in three other companies. Mr. Ricks reviewed the history of litigation over the last 40 years stating that the current risk in holding tobacco securities was in the form of the state Medicaid suits and potential FDA regulation of tobacco. Mr. Ricks also reviewed the historical returns generated by tobacco stocks noting that as a group they had outperformed the S&P 500 Index in nine of the last twelve years. In Mr. Ricks' opinion, the litigation risk was overdiscounted and there were several avenues to resolution of the litigation. He cited strong fundamental industry growth prospects versus the S&P 500 Index and the fact that many of the research firms used by the internal staff and the funds' external managers rated tobacco stocks, particularly Philip Morris, strong buys or holds. He recommended against divestiture based on current risk adjusted return expectations. Considerable discussion ensued concerning the advantages and drawbacks to divestiture.

The conclusion of the Board of Directors was that the Corporation's contract with the U. T. Board imposed a fiduciary responsibility on the Corporation in the management of the investments of the System's funds in accordance with the prudent person standard. This is the strict trust standard that requires a trustee to manage a beneficiary's funds with the same amount of prudence, discretion and intelligence that it exercises in the management of its affairs. Specifically, this standard requires the Corporation to base all investment decisions relating to the PUF solely upon economic considerations, including the probable income and probable safety of an investment. Based upon its review of the PUF's tobacco-related stocks, the Board of

Directors determined that the risk adjusted returns expected for such stocks did not warrant disposition at this time.

### **Report of Audit and Ethics Committee**

Mr. Evans, as Committee Chairman, reported that the Committee had met earlier in the day. The Committee had reviewed the Corporation's financial statements for the two months since inception. In addition, the Committee reviewed and approved an audit plan involving the use of a Big Six accounting firm to provide audit services. The selection was expected to be in late July following a request for proposals. Mr. Evans also reported that the Committee had reviewed compliance requirements as well as the UTIMCO Code of Ethics. Finally, he reported that the mandate for the Committee would be circulated for approval by the Board of Directors via unanimous written consent.

(At this point Mr. Evans departed the meeting.)

### **Presentation by Fayez Sarofim & Co.**

Mr. Ricks introduced the next item stating that Fayez Sarofim was the longest running manager having been hired in 1988. The firm managed approximately \$150 million of large cap growth equities for the PUF and LTF. He pointed out that the firm had added considerable value over the S&P 500 Index having generated an average return of 16.3% for the PUF versus 14.6% for the S&P 500 Index for the seven years since inception.

Mr. Ralph Thomas of Fayez Sarofim & Co. reviewed the performance for the PUF noting that the firm had outperformed the S&P500 Index since June 30, 1988 by 18.0% to 15.4%. He also presented the firm's economic and market outlook plus the firm's global growth investment strategy which was focused on companies involved in geographic expansion, new product development or restructuring/cost cutting. Their strategy was based on the expectation that a) the profit growth of U.S. multinational companies would exceed that for the U.S. economy as a whole and b) economic growth of emerging economies with large populations and a rising middle class would exceed that of the U.S. He concluded by stating that he believed that the firm expected continued economic expansion but at a slower pace and that the stock market would place increasing emphasis on earnings predictability.

(At this point Mr. Loeffler departed the meeting.)

### **Private Investments - The Beacon Group III - Focus Value Fund, L.P.**

Messrs. Boisi, Mandel and Wilkinson, principals of The Beacon Group made a brief presentation to the Board of Directors citing their individual credentials and accomplishments and discussing their proposed investment strategy (all of which are contained in the staff's The Beacon Group III - Focus Value Fund, L.P. Due Diligence Review and Recommendation).

At the conclusion of their presentation, the Beacon principals left the room and the UTIMCO Board of Directors debated the merits of a commitment to the Beacon Group III - Focus Value Fund. Mr. Hicks asked the staff why their investment memorandum recommended a commitment of only \$15 million. Mr. Long replied that the requested commitment is smaller

than usual for a corporate acquisition fund because Beacon is a new investment bank and the fund is a first-time fund in the sense that this will be the first time Mr. Mandel and Mr. Wilkinson have worked together.

Mr. King said that the fact that the Beacon Focus Value Fund is Beacon's first fund is a plus, since Mr. Boisi and Mr. Mandel worked together for many years at Goldman Sachs and the management group is therefore not a start-up in the usual sense. Mr. Hicks added that, in light of the long-term track record of the investment managers, a \$25 million commitment would be more appropriate.

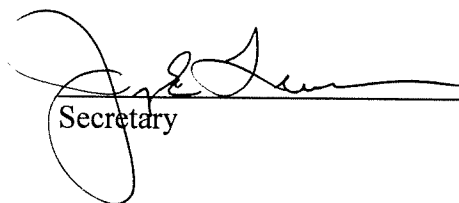
However, the Board of Directors identified the following issues as critical to the negotiation of an agreement with the Beacon Group for an investment in the Beacon Focus Value Fund:

- co-investments must be unpromoted and favorable terms granted to others in a co-investment group must be granted to the PUF and LTF on the so-called "most favored nations" basis; and,
- a member of the UTIMCO staff must have a seat on the Beacon Focus Value Fund advisory committee in order to insure that no conflicts of interest arise between Beacon's mergers and acquisitions business and the group's role as fiduciary for the PUF and LTF in the investment of their funds.

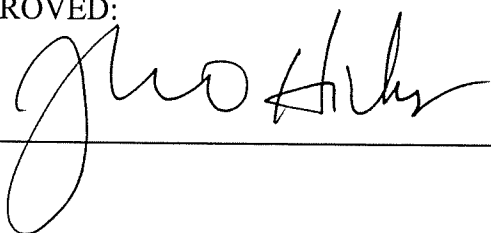
Following this discussion, the Board of Directors, by motion duly made, seconded and carried by a unanimous vote, approved a \$25 million commitment to the Beacon Group III - Focus Value Fund, L.P. subject to further due diligence and to obtaining the terms set out in the bullet points above in addition to market terms and conditions on all other contractual provisions.

(Given the late hour, items on the agenda relating to the discussion of Short Term Fund Management and the appointment of a Compensation Committee were deferred to the next meeting.)

There being no further business to come before the Board of Directors, the meeting was adjourned at approximately 5:45 p.m.

  
Secretary

APPROVED:

  
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