The California State University
Office of the Chancellor

Annual Investment Report

July 1, 2002 – June 30, 2003
Prepared by
The Office of Financing and Treasury
Summary

At the January 1997 meeting, the Board of Trustees approved the creation of a centralized investment program to manage the investment of funds held in California State University trust accounts. In addition, the Board approved an investment policy consistent with the authority provided in existing statutes to guide the university in administering the investment program. A copy of the investment policy is provided in Attachment A.1. The Board also agreed that an external fund manager should be hired to invest the funds consistent with the investment policy of the Board of Trustees. The firm of Metropolitan West Securities, Inc. was hired through a competitive process to manage an investment program for the California State University.

This agenda item reports the results of the CSU investment program administered by Metropolitan West for the twelve months ending June 30, 2003. In addition, results are provided for the Surplus Money Investment Fund (SMIF) and Local Agency Investment Fund (LAIF). The State Treasurer administers SMIF and LAIF, which are available to the campuses as investment options.

Market Recap

The past year has been marked by sharply falling interest rates. The Federal Funds overnight target rate has fallen from 1.75% to 1.00%. This happened in two stages. The FOMC (the policy making committee at the Federal Reserve) cut interest rates from 1.75% to 1.25% on November 6, 2002. On June 25, 2003, the Federal Reserve again cut the rate to 1.00%. The U.S. Treasury 2-year Note rate fell from 2.819% at the end of June 2002 to 1.308% at June 30, 2003 and the 10-year Note rate fell from 4.797% to 3.513% in that same time period.

Investor confidence improved considerably in the last 6-months, which was reflected in higher stock prices and tighter credit spreads. Current expectations are for GDP to exceed 3% in the second half of 2003. Furthermore, the fear of deflation should abate considerably if, in fact, we see the stronger GDP growth that is expected.

This environment has been generally favorable to participants in the three fixed income accounts, most notable on the Total Return and Long-Term accounts. A jobless recovery along with geopolitical unrest provided the backdrop for strong returns for fixed income securities. In keeping with the CSU investment policy (Attachment A.1) when investing the campus funds, the primary objective is to safeguard the principal, meet the liquidity needs of the campus and to return an acceptable yield.
CSU Short-Term Investment Account Performance

As of June 30, 2003, the asset balance in the Short-Term account totaled $209 million. The objective of the Short-Term account is to maximize current income along with preservation of capital. Consistent with the CSU investment policy, the portfolio is restricted to U.S. Treasury securities, mortgage backed securities, government agency securities, and highly rated corporate securities. State law prohibits the investment of these funds in equity securities. The portfolio’s holdings by sector for the Short-Term account are as follows:

California State University Short-Term Account
Sector Breakdown as of 06/30/2003

- Cash Fund: 21%
- Corporate Securities: 48%
- U.S. Government Agencies: 20%
- U.S. Treasuries: 8%
- MBS: 3%

The Short-Term account has provided a return of 2.42 percent during the 12 months ended June 30, 2003. This return outperformed the 12-month return for the Local Agency Investment Fund by .22 percent.
CSU Total Return Investment Account Performance

The objective of the Total Return account is to maximize medium term total return. The account is invested in a diversified portfolio of fixed income securities of varying maturities with approximate portfolio duration of 3.75 to 5.75 years. The account is benchmarked versus the Merrill Lynch 5-7 year Treasury Index, and is structured to outperform both the Short-Term account and LAIF over a 5-7 year investment horizon. As of June 30, 2003, the net asset value of the account was $178 million.

Consistent with the CSU investment policy, the Total Return account portfolio is restricted to U.S. Treasury securities, mortgage backed securities, government agency securities, and highly rated corporate securities. State law prohibits the investment of these funds in equity securities. The portfolio’s holdings by sector for the Total Return account are as follows:
The Total Return account has provided a return of 8.69 percent during the 12 months ended June 30, 2003. This return exceeded the 12-month return for the Local Agency Investment Fund by 6.49 percent. Because of the funds defensive strategy, which emphasizes preservation of principal, the portfolio has a shorter duration, which led it to under perform the Merrill Lynch 5-7 Year Treasury Index by 3.41 percent.
CSU Long-Term Account Investment Performance

The investment objective of the Long-Term account is to maximize returns for funds that can be invested for a longer term. This account invests in a diversified portfolio of fixed income securities of varying maturities with approximate portfolio duration of 5 to 7 years. As of June 30, 2003, the net asset value of the account was $74 million. Consistent with the CSU investment policy, the portfolio is restricted to U.S. Treasury securities, mortgage backed securities, government agency securities, and highly rated corporate securities. State law prohibits the investment of these funds in equity securities. The portfolio’s holdings by sector for the Long-Term account are as follows:

The Long-Term account has provided a return of 11.84 percent during the 12 months ended June 30, 2003. This return exceeded the 12-month return for the Local Agency Investment Fund by 9.64 percent. Because of the defensive strategy to shorten duration in the CSU Long-Term account, the portfolio under performed the Merrill Lynch 7-10 Year Treasury Index by 2.16 percent.
Surplus Money Investment Fund (SMIF)

The Surplus Money Investment Fund (SMIF) is a vehicle used by the State Treasurer to invest state funds in a short-term pool at virtually no risk. Cash on this account is available on a daily basis. SMIF is managed by the State Treasurer’s Office. The portfolio’s composition includes CD’s and Time Deposits, U.S. Treasuries, Commercial Paper, Corporate Securities, and U.S. Government Agencies. As of June 30, 2003, the balance was $35.4 million.

SMIF Performance Report
Apportionment Yield Rate

<table>
<thead>
<tr>
<th>Date</th>
<th>Yield Rate</th>
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<tbody>
<tr>
<td>06/30/2003</td>
<td>1.859%</td>
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<tr>
<td>12/31/2002</td>
<td>2.468%</td>
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SMIF Past Performance 1997-2003

<table>
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<th>Year</th>
<th>Average</th>
<th>High</th>
<th>Low</th>
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</thead>
<tbody>
<tr>
<td>1997-2003</td>
<td>4.798%</td>
<td>6.493%</td>
<td>1.859%</td>
</tr>
</tbody>
</table>

Local Agency Investment Fund (LAIF)

The Local Agency Investment Fund (LAIF) is a vehicle used by the State Treasurer to invest local agency funds. LAIF is administered by the State Treasurer’s Office. All investments are purchased at market, and market valuation is conducted quarterly.

LAIF Performance Report
Quarter ending 06/30/2003

Apportionment Rate: 1.77%
The California State University Investment Policy

The following investment guidelines have been developed for CSU campuses to use when investing funds.

Investment Policy Statement

The objective of the investment policy of the California State University is to obtain the best possible return commensurate with the degree of risk that the CSU is willing to assume in obtaining such return. The Board of Trustees desires to provide to each campus president the greatest possible flexibility to maximize investment opportunities. However, as agents of the trustees, campus presidents must recognize the fiduciary responsibility of the trustees to conserve and protect the assets of the portfolios, and by prudent management prevent exposure to undue and unnecessary risk.

When investing campus funds, the primary objective of the campus shall be to safeguard the principal. The secondary objective shall be to meet the liquidity needs of the campus. The third objective shall be to return an acceptable yield.

Investment Authority

The California State University may invest monies held in local trust accounts under Education Code Sections 89721 and 89724 in any of the securities authorized by Government Code Section 16430 and Education Code Section 89724, listed in Section A subject to limitations described in Section B.

A. State Treasury investment options include:

- Surplus Money Investment Fund (SMIF)
- Local Agency Investment Fund (LAIF)

B. Eligible securities for investment outside the State Treasury, as authorized by Government Code Section 16430 and Education Code Section 89724, include:

- Bonds, notes or obligations with principal and interest secured by the full faith and credit of the United States;
- Bonds, notes or obligations with principal and interest guaranteed by a federal agency of the United States;
• Bonds or warrants of any county, city, water district, utility district or school district;
• California State bonds or bonds with principal and interest guaranteed by the full faith and credit of the State of California;

• Various debt instruments issued by: (1) federal land banks, (2) Central Bank for Cooperatives, (3) Federal Home Loan Bank Bd., (4) National Mortgage Association, (5) Federal Home Loan Mortgage Corporation, and (6) Tennessee Valley Authority;

• Commercial paper exhibiting the following qualities: (1) “prime” rated, (2) less than 180 days maturity, (3) issued by a U.S. corporation with assets exceeding $500,000,000, (4) approved by the PMIB. Investments must not exceed 10 percent of corporation’s outstanding paper, and total investments in commercial paper cannot exceed 30 percent of an investment pool;

• Bankers’ acceptances eligible for purchase by the Federal Reserve System;

• Certificates of deposit (insured by FDIC, FSLIC or appropriately collateralized);

• Investment certificates or withdrawal shares in federal or state credit unions that are doing business in California and that have their accounts insured by the National Credit Union Administration;

• Loans and obligations guaranteed by the United States Small Business Administration or the United States Farmers Home Administration;

• Student loan notes insured by the Guaranteed Student Loan Program;

• Debt issued, assumed, or guaranteed by the Inter-American Development Bank, Asian Development Bank or Puerto Rican Development Bank;

• Bonds, notes or debentures issued by U.S. corporations rated within the top three ratings of a nationally recognized rating service;

C. In addition to the restrictions established in Government Code Section 16430, the CSU restricts the use of leverage in campus investment portfolios by limiting reverse repurchase agreements used to buy securities to no more than 20 percent of a portfolio. Furthermore, the CSU:

• Prohibits securities purchased with the proceeds of a reverse repurchase from being used as collateral for another reverse repurchase while the original reverse repurchase is outstanding;
• Limits the maturity of each repurchase agreement to the maturity of any securities purchased with the proceeds of the repurchase (but in any event not more than one year) and;

• Limits reverse repurchase agreements to unencumbered securities already held in the portfolio.

Investment Reporting Requirements

A. Annually, the Chancellor will provide to the Board of Trustees a written statement of investment policy in addition to a report containing a detailed description of the investment securities held by all CSU campuses and the Chancellor’s Office, including market values.

B. Each campus will provide no less than quarterly to the Chancellor a report containing a detailed description of the campus’s investment securities, including market values. A written statement of investment policy will also be provided if it was modified since the prior submission. These quarterly reports are required:

• to be submitted to the Chancellor within 30 days of the quarter’s end

• to contain a statement with respect to compliance with the written statement of investment policy; and

• to be made available to taxpayers upon request for a nominal charge.