The Regents of the University of California

COMMITTEE ON INVESTMENTS
September 14, 2011

The Committee on Investments met on the above date at UCSF–Mission Bay Community Center, San Francisco.

Members present: Representing the Committee on Investments: Regents Crane, Hallett, Kieffer, Makarechian, Marcus, Schilling, and Wachter; Advisory member Anderson; Staff Advisor Smith

Representing the Investment Advisory Group: Members Fisher, Martin, Rogers, Samuels, and Chief Financial Officer Taylor; Consultant Klosterman

In attendance: Faculty Representative Powell, Secretary and Chief of Staff Kelman, Associate Secretary Shaw, General Counsel Robinson, Chief Investment Officer Berggren, and Recording Secretary McCarthy

The meeting convened at 2:40 p.m. with Committee Chair Wachter presiding.

1. **APPROVAL OF MINUTES OF PREVIOUS MEETING**

Upon motion duly made and seconded, the minutes of the meetings of June 22, 2011, and July 13, 2011, were approved.

2. **SECOND QUARTER 2011 AND FISCAL YEAR 2010-2011 INVESTMENT PERFORMANCE SUMMARY**

[Background material was mailed to Regents in advance of the meeting, and a copy is on file in the Office of the Secretary and Chief of Staff.]

Chief Investment Officer Berggren reviewed the performance summary for the quarter and fiscal year ending June 30, 2011. All portfolios had excellent performance for the quarter. The UC Retirement Plan (UCRP) rose 1.48 percent; the General Endowment Pool (GEP) rose 1.24 percent; all portfolios outperformed their benchmarks for the quarter. For the fiscal year, the UC Entity, the aggregate of all assets managed by the Office of the Treasurer, was up 17.63 percent; UCRP rose 22.45 percent; GEP rose 20.49 percent; the Total Return Investment Pool (TRIP) was up 11.26 percent; all portfolios outperformed their benchmarks for the fiscal year.

Ms. Berggren reported that manager and asset selection were the main contributors to performance. For the three-year period ending March 31, 2011, GEP returns ranked in the top quartile of the Cambridge Associates' peer universe of universities with assets over $1 billion and in the top quartile based on preliminary data on returns through

June 30, 2011. GEP returns were in the middle of that peer universe for the one-year period ending March 31, 2011. For the fiscal year ending June 30, 2011, UCRP ranked within the top quartile of the Wilshire Trust Universe Comparison Service (TUCS) for public plans with assets over $1 billion.

Turning to a market overview, Ms. Berggren stated that a considerable slowdown in global economic momentum weighed heavily on markets in the quarter. There was unrest in the Middle East, as well as renewed concerns about debt and possible sovereign default problems. Returns in the second quarter showed a much more defensively oriented market set and the U.S. market reflected much concern about macroeconomic trends. European equities performed surprisingly well, in spite of the escalation of debt worries. Emerging market equities had a negative return for the quarter, held back by inflationary concerns and monetary tightening. For the fiscal year to date, the Russell 3000 was up 32.4 percent; the MSCI World ex-U.S. rose 30.3 percent; emerging markets were up 27.8 percent; Barclays Capital Aggregate Index rose 3.9 percent; U.S. high-yield bonds were up 15.3 percent.

Further reporting on the performance of UC funds for the quarter ending June 30, 2011, Ms. Berggren stated that TRIP rose 1.5 percent and the UC Entity was up 1.3 percent. For the six-month period ending June 30, 2011, UCRP rose 5.4 percent; GEP was up 4.7 percent; TRIP rose 3.5 percent; the UC Entity was up 4.4 percent. For the longer term, absolute returns have shown meaningful improvement over one, three, and five-year periods. UCRP had a compound return of 9.35 percent over a 20-year period, outperforming its benchmark by 32 basis points (bps). UCRP outperformed its policy benchmark in 75 percent of the last 20 fiscal years.

Committee Chair Wachter commented that, while many of the benchmarks are objective, it is very difficult to find benchmarks for areas such as private equity. He noted the importance of looking at the assumptions about the pension fund, given the difficult investment climate of the past ten years.

Regent Crane asked what percentage of assets are in fixed income. Ms. Berggren responded that about 20 percent are in fixed income at the current time, down from about 40 percent ten years prior. Regent Crane pointed out that ten-year bond rates were very high in 1992 and that the values of fixed income portfolios increased as long-term rates dropped.

Regent Kieffer stated that he was more interested in UC's performance against other institutions, than against benchmarks. He commented that it is important to get a sense of UC's investment performance over long periods of time, both in the past and projecting forward.

Regent Crane stated that past returns had been affected a great deal by declining bond rates. In response to a question from Regent Crane, Ms. Berggren stated that the approximately 20 percent of the portfolio currently invested in fixed income has about a five-year duration. Regent Crane stated his belief that fixed income would not earn more than four percent currently. He pointed out that, in order to earn an overall 7.5 percent return net of fees, with 20 percent of the portfolio invested in fixed income, equities would have to earn very high returns.

Committee Chair Wachter commented that, although there have been significant market problems during certain periods of the past 20 years, it is nonetheless helpful to see the overall 20-year performance. With the exception of fixed income and private equity, ten-year returns have been flat.

Investment Advisory Group consultant Klosterman stated his opinion that projected performance going forward would be higher than that of the past ten years and lower than that of the past 20 years. He said that no one would expect to achieve seven percent returns on intermediate-term government bonds currently.

Regent Crane stated that a 7.5 percent return on a portfolio with a 20 percent investment in fixed income would require returns on equity much higher than could be reasonably expected at the current time. He stated his opinion that, even though UC's assumed rate of return is lower than that of other pension funds, it is much higher than can be realistically anticipated.

Investment Advisory Group Member Samuels asked if the benchmarks were net of fees and expenses. Committee Chair Wachter responded that UC's investment returns are reported net of fees, but the benchmarks are gross. Committee Chair Wachter added that it is common practice to use benchmarks without deducting fees and expenses. Faculty Representative Anderson stated that, since the benchmarks are not actively managed, they would have low costs of only about ten bps. Mr. Terry Dennison of Mercer Investment Consulting stated that UC's management costs for index funds would be roughly one bp for domestic equity and two bps for fixed income.

Investment Advisory Group Member Rogers expressed his opinion that UC should compare its returns with those of institutions with endowment funds of similar size. Mr. Klosterman pointed out that differences in allocation must also be considered, since the difference in performance would be driven primarily by differences in allocation.

Regent Crane stated that the level of projected investment returns is very important. Committee Chair Wachter agreed that assumptions for absolute portfolio returns compared to levels that realistically might be expected over the upcoming ten or 20 years are key. Regent Crane pointed out that General Motors had assumed a nine percent investment return for its pension fund and therefore under-contributed in the 1980s, creating a huge subsequent liability, which later affected its ability to function as an automobile company. He stated his view that UC acted similarly by not contributing to its pension fund for years, and was still inflating its projected investment return assumption, although by less than some other institutions. Committee Chair Wachter commented that the Committee on Finance, rather than the Committee on Investments, is responsible for setting projected investment return assumptions.

Turning to asset class performance for the quarter, Ms. Berggren stated that equity returns were mixed; fixed income returns outperformed equity returns. The cross asset class, real estate, and private equity did very well in the quarter. For the six-month period ending June 30, 2011, U.S. equity, non-U.S. equity, U.S. high-yield bonds, emerging market debt, Treasury Inflation-Protected Securities (TIPS), private equity, and real estate had good returns. Private equity and real estate rebounded strongly.

Regarding asset allocation, Ms. Berggren reported that UCRP had a modest overweight in private equity, and an underweight in core fixed income and TIPS. GEP was overweight in private equity, and underweight in core fixed income, TIPS, and absolute return.

Ms. Berggren stated that an analysis of performance attribution in UCRP showed that core bonds added 17 bps to the active return, absolute return added 54 bps, and real estate added ten bps. Asset allocation contributed ten bps to active return and security selection contributed 71 bps, for a total of 81 bps in active return. In GEP, core bonds added six bps and absolute return added 223 bps, for a total of 247 bps in excess of the benchmarks.

Regarding contribution to risk in UCRP, Ms. Berggren stated that 75 percent of total risk comes from the public equity portfolio; almost 80 percent of active risk stems from the overweight in private equity. In response to a question from Regent Crane, Ms. Berggren stated that risk related to volatility, and would affect how the portfolio is handled. In response to a further question from Regent Crane, Committee Chair Wachter stated that the average life of the portfolio’s liabilities is 16 years. Regent Crane stated that volatility is not so significant with such long-term liabilities. Ms. Berggren stated that it would be appropriate to have a separate Committee session on risk factors. Regent Crane stated that, to him, risk means the possible loss of principal. Mr. Klosterman stated that the Office of the Treasurer’s view of risk is more sophisticated than simply tracking volatility. Committee Chair Wachter stated that the measure of risk used by the University is standard throughout the investment community. He agreed that it would be beneficial to have a Committee session devoted to a discussion of risk. He also stated that market volatility is important, since it can result in the over or underfunding of UCRP, and thus lead to funding and investment decisions.

Investment Advisory Group Member Fisher agreed that it would be important to have a discussion about risk. He stated that greater weight is sometimes attributed to measureable aspects, but that, to him, risk means the chance of losing money more than volatility.

Managing Director Jesse Phillips stated that volatility is only one measure of risk, and that the Office of the Treasurer also uses downside risk measures in its asset allocation process. Ms. Berggren stated that an involved factor analysis is used, but that measures of volatility are used to communicate areas of risk to the Committee, for example that the public equity portion of the portfolio currently contributes a large part of the active risk in the portfolio.

Mr. Rogers expressed his opinion that UC should compare its investment results with those of endowments of equal size. He pointed out that the Cambridge Associates' universe includes endowments of approximately $1.5 billion, while UC has an almost $6 billion endowment. He stated that UC should compare itself with endowments of over $5 billion. Committee Chair Wachter said that UC could compare itself to both groups. Ms. Berggren explained that it is difficult to compare UC's endowment to other large endowments, because they have significantly different asset allocations.

Mr. Samuels pointed out that UC has a distinct pension plan while few other institutions have a similar arrangement. He stated that there are very few universities with a $71 billion pension investment and a $6 billion endowment, which complicates comparisons. Committee Chair Wachter commented that comparisons could be made by comparing the endowment fund with other endowment funds, and the pension fund to other pension funds. He noted that the asset allocations in the endowment and the pension funds are quite different.

In response to a question from Mr. Samuels, Ms. Berggren stated that the securities lending program lent from both the endowment and pension funds. Mr. Samuels commented that there are multiple interactions between the funds, and reiterated his opinion that it would be difficult to find a comparative institution with a situation similar to UC's.

Mr. Klosterman expressed his view that it would be beneficial to benchmark UC's funds' performances against all endowments of $5 billion or greater. He stated that the interplay between the pension fund and the endowment fund would have a small effect, and, if anything, would give UC an advantage.

Mr. Anderson cautioned that care must be taken when evaluating how to use information gained from such comparisons of UC's endowment with endowments of similar size, but with different investment policies. Such comparisons would not indicate whether the Office of the Treasurer is performing effectively, but could reveal the appropriateness of UC's asset allocation. Mr. Anderson noted that asset allocation is not set by the Office of the Treasurer, but rather by the Committee on Investments.

Regent Crane said that UC has some funds that act as endowment funds, but are not actually endowment funds. Investment Advisory Group Member and Chief Financial Officer Taylor stated that it might be beneficial to revisit the policy on Funds Functioning as Endowment (FFEs), which he characterized as quasi-endowments, to determine if UC has too much liquidity. Committee Chair Wachter commented that many hedge funds have 90-day or six-month liquidity. Regent Crane expressed his opinion that UC has a great deal of excess liquidity.

Mr. Rogers raised the question of whether UC should include campus foundation monies with its endowment, since UC is one institution and is responsible for those funds. He stated that the decision had been made not to manage all endowment funds including the campus foundations together, but he pointed out that the University is responsible for the returns on the foundations’ funds. Regent Marcus stated that this issue had been addressed many times in the past and that campus groups have preferred to control their foundations’ investments. In response to a question from Regent Crane, Mr. Taylor stated that a donor can choose where his or her donation would be invested. Mr. Rogers expressed his opinion that the returns on the campus foundations should be included in analyses of returns on University funds. Regent Crane noted that it may be to UC’s benefit to have multiple vehicles from which donors could choose. Committee Chair Wachter recalled that significant discussions had been held with the campus foundations and that the current system of management, supervision, and reporting was the result.

The meeting adjourned at 3:20 p.m.

Attest:

Secretary and Chief of Staff