The Regents of the University of California

COMMITTEE ON INVESTMENTS
September 16, 2015

The Committee on Investments met on the above date on the above date at the Student Center, Irvine Campus.

Members present: Regents De La Peña, Gorman, Kieffer, Makarechian, Oved, Pattiz, Pérez, Sherman, and Zettel; Ex officio members Lozano, Napolitano and Varner; Advisory members Hare and Ramirez; Faculty Advisors Acker and Richmond

In attendance: Regents Blum, Davis, Gould, Island, Newsom, Ortiz Oakley, Reiss, and Ruiz, Regents-designate Brody and Schroeder, Faculty Representative Chalfant, Secretary and Chief of Staff Shaw, General Counsel Robinson, Chief Compliance and Audit Officer Vacca, Chief Investment Officer Bachher, Provost Dorr, Executive Vice President and Chief Financial Officer Brostrom, Executive Vice President and Chief Operating Officer Nava, Senior Vice Presidents Henderson and Peacock, Vice Presidents Budil, Duckett, Humiston, and Sakaki, Chancellors Block, Blumenthal, Gillman, Hawgood, Katehi, Leland, Wilcox, and Yang, and Recording Secretary McCarthy

The meeting convened at 12:00 p.m. with Committee Vice Chair Sherman presiding.

UPDATE ON FISCAL YEAR 2014-15 INVESTMENT HIGHLIGHTS

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

Committee Vice Chair Sherman introduced Chief Investment Officer (CIO) Bachher to review the activities of the Office of the CIO for the 2014-15 fiscal year.

Mr. Bachher presented investment results for the 2014-15 fiscal year, beginning by providing background on the relationship between the Committee on Investments and the Office of the CIO. The Office of the CIO works with the Committee to propose long-term investment goals, or strategic asset allocation, for a three- to five-year time horizon for the endowment, retirement assets, and working capital portfolios. The Regents delegate the implementation of that strategy to the Office of the CIO, which is afforded the flexibility to invest within specified allocation ranges, allowing nimbleness that was particularly necessary in the global economic climate during the past fiscal year. The Office of the CIO focuses on risk management across its investment products, each having a different return and risk profile. For example, the University's retirement assets fund the retirement benefits upon which UC employees depend. The General Endowment Pool (GEP) funds 5,400 endowments systemwide that depend on its annual payouts. The working capital portfolios provide day-to-day operating capital to UC. Since coming to the University Mr. Bachher has reviewed how these products had been managed in the past and how they were invested.

During the course of the fiscal year, market risks increased because of various factors such as the Chinese economy, Europe and Japan's injecting new stimulus into their economies through quantitative easing, geopolitics, and changing oil prices. While the market yielded 0.7 percent for the fiscal year on a globally invested passive index, UC portfolios earned roughly four percent because they were actively managed and UC was nimble in its management. For the past decade, fixed income instruments had been low-returning assets. Earning the high equity returns common since the depths of the global financial crisis would be difficult in the current low-return environment and managing costs would be extremely important. Mr. Bachher expressed his goal to increase collaboration between the Office of the CIO and the larger University. The size and scale of the $98 billion UC Entity allows efficient investment of capital. More importantly, the Office of the CIO could leverage the knowledge and collaborative power of the University to find investment opportunities. In just the past year, his office found more than $1 billion in public and private investment opportunities arising from the collaborative network of the University.

Mr. Bachher reported that the GEP held $9 billion, the UC Retirement Plan (UCRP) and the UC Retirement Savings Plan together held $75 billion, and the working capital portfolios close to $15 billion. Of these holdings, approximately $31 billion was invested in fixed income assets managed in-house by the Office of the CIO. About $50 billion, or half of the UC Entity, was invested externally in public equities, with 30 percent of that amount invested passively in index holdings and 70 percent with external active managers. Other investments that diversify the portfolio include private equity, real assets, real estate, and hedge funds or absolute return, totaled $16 billion. The portfolio also held $3.8 billion in cash. Taking profits, and simplifying the portfolios during the fiscal year to eliminate duplication of investment strategies and to save costs, resulted in $10 billion of cash inflows to the portfolio, of which $6 billion had been redeployed. An additional $1 billion cash was invested in equities during the last week of September, taking advantage of market volatility.

Considering lower energy prices, it was likely that inflation would remain minimal, resulting in continued low interest rates in the bond market. The Federal Reserve Board had stimulated the economy through quantitative easing, injecting capital and enabling growth that resulted in a rising stock market. Quantitative easing had not ended, since the Federal Reserve held $4.5 trillion in fixed income securities and continued to reinvest its maturities both in Treasuries and mortgages. There had been slower economic growth in the United States, and growth outside the U.S. had not picked up in spite of quantitative easing in Europe and Japan. Asset values were higher than would be supported by the real economy. Recent market volatility offered pockets of opportunity for investing.

Mr. Bachher discussed the GEP and thanked UC Santa Barbara for choosing the Office of the CIO to manage its $140-million foundation in the GEP, effective July 1, 2015. He also thanked UC San Diego and UC Irvine for electing to move $240 million to the GEP from their working capital pools. The GEP earned 7.2 percent for the fiscal year and 11.3 percent annually over the past five years. The $98 billion UC Entity earned $3.2 billion from market gains, including

$600 million in the GEP, $2.3 billion in the pension, and $300 million in the working capital pools. The GEP paid out 4.75 percent annually to 5,400 endowments within the University, which amounted to $270 million for the fiscal year. Over the past decade, the GEP paid out $2.3 billion to specific endowments across the University. Over the last five years, the GEP's returns were in the top quartile of peer universities with endowments over $5 billion.

About five years prior, the Office of the CIO began co-investing alongside its external private equity managers without paying fees, a growing trend in the industry. About ten percent of the GEP, or $800 million, was invested in private equity funds. Of this amount, about 40 percent was in co-investments, which returned 51 percent for the fiscal year and 40 percent annually for three years. Mr. Bachher anticipated increasing co-investments over the upcoming three years by using the size and scale of the GEP and UCRP to increase co-investment opportunities. The Office of the CIO sold close to $1.7 billion in private equity holdings in secondary markets over the past 30 months, roughly at par, and had rationalized its private equity portfolio by 100 funds, down to 40 private equity managers. Having fewer external private equity managers would allow the Office of the CIO to have deeper value-added relationships with its managers to increase deal flow in co-investments. Co-investing had saved $100 million in fees over five years.

Mr. Bachher discussed the University's retirement assets. Future retirement security of UC employees would be a combination of the defined benefit (DB) plan, the participant-directed defined contribution (DC) plan, and Social Security. The UC Regents won *Institutional Investor's* award for the UCRP as the best large U.S. public pension plan of 2015. There were 20,000 participants in UCRP, a mature plan with two retirees for every active participant. Over the upcoming five years, 35 percent of UC's 140,000-member workforce would retire. Each month, UC retirees received an average of $3,400 from UCRP, totaling $2 billion in annual benefit payouts. Annual contributions to UCRP were $1.2 billion. The prior year, the University lent $700 million to UCRP from the working capital to reduce UCRP's unfunded liability. During the 2014-15 fiscal year, UCRP's funding ratio increased from 84 percent to 89 percent. With the current 7.5-percent discount rate, UCRP's liabilities stood at $60 billion. In the current lower-return environment, if the discount rate were decreased to 7.25 percent, UCRP's liabilities would increase by about $2 billion. To make up that difference, a $50 billion pension plan would have to earn four percent more in annual returns. UCRP's assets were $55 billion as of June 30, 2015. The lower-return environment would place more pressure on investment returns. During the fiscal year, UCRP earned 2.2 percent from market gains and 4.5 percent overall net of fees for the year. For the longer term, UCRP gained 11 percent annually over the past five years and 8.4 percent annually over the past 20 years. Over the past ten years, UCRP earned about $27 billion from the market. Mr. Bachher anticipated lower returns in the future. The key driver of UCRP's performance was public equities, which comprised more than half UCRP's holdings. Over the past ten years, UCRP performance was in the top decile of its U.S. peers. In the past year, UCRP was one of the top three performing pensions in the nation.

Mr. Bachher reviewed the rapid global changes that occurred during the fiscal year. China had been an area of economic growth, but then its growth sharply decelerated. Europe and Japan injected quantitative easing in attempts to stimulate their economies. Energy prices went from highs of $100 per barrel of crude oil to $40. The Office of the CIO had to respond quickly to these changing marketplace dynamics by over-weighting or under-weighting market sectors, which contributed 20 percent of the performance above the benchmark. Rationalizing, or simplifying, the portfolio during the fiscal year reduced the number of stocks from 12,000 to 6,000, lowered costs and yielded another 20 percent of the performance above benchmark.

The Office of the CIO's real estate portfolio totaled close to $4 billion across the GEP and the UCRP. The Office's real estate team worked with the UC campuses to contribute expertise and explore partnering in various real estate projects. Mr. Bachher encouraged the chancellors and campus chief financial officers to consider using the Office of the CIO like an investment banker for real estate opportunities.

Mr. Bachher discussed the increasingly important UC Retirement Savings Plan (UCRSP), the DC plan of UC employees' voluntary contributions. The UCRSP grew from $11 billion ten years prior to $20 billion at the end of the 2014-15 fiscal year, growing roughly $1 billion per year. The Office of the CIO reduced the number of funds options for investors from 192 to 16, in line with other DC plans. One quarter of the fund options are target-date retirement funds. His office would review the underlying offerings in the target-date funds. Mr. Bachher encouraged the University to institute auto-enrollment to encourage employee retirement preparedness.

Mr. Bachher reported that he and Executive Vice President and Chief Financial Officer Brostrom had reviewed ways to use the most effective blend between the Short Term Investment Pool (STIP) and the Total Return Investment Pool (TRIP) working capital portfolios to provide more operating income to UC campuses. TRIP had been created in 2008 from excess savings in STIP, and was invested for a longer three- to five-year time horizon, while STIP was invested like a money-market fund. Since inception, TRIP earned eight percent annually compared with STIP's two percent per year. Mr. Bachher and Mr. Brostrom have agreed to find a way to move $1.2 billion from STIP to TRIP. TRIP would hold two-thirds of the working capital and STIP one-third. TRIP's risk would be managed to be aligned with the needs of the University.

Mr. Bachher recalled his commitment a year prior to work with UC stakeholders and the broad University community to understand what it meant to include sustainable investing into the Office of the CIO's investment decision-making framework. The prior week, his office released its statement of sustainability values and beliefs. It was important to understand sustainability issues, particularly in this time when proliferation of an issue on social media could erode a company's market capitalization very quickly. During the course of the past fiscal year, the Office of the CIO sold its direct holdings in coal mining and oil sands companies on the basis of economics, including decreasing global demand, increasingly unfavorable regulatory environment, and the high threat of substitution of other energy sources. Mr. Bachher anticipated that sustainability issues such as the availability of water and the condition of topsoil would affect consideration of investing in California agricultural land, commodities, and related businesses. The Office of the CIO would include consideration of long-term carbon prices in its analysis of future financial forecasts of electric utilities. Mr. Bachher reported that his office would work with the broader University community to understand the implications of carbon pricing on utility investments. Environmental sustainability, social responsibility, and prudent governance principles are not in conflict with the Office of the CIO's fiduciary duty. In fact, fiduciary duty requires systematic attention to sustainability factors.

Mr. Bachher concluded by stating that the Office of the CIO had a good year, but he did not anticipate the same level of value-added returns in the current challenging market. His office would continue to follow basic investment principles, a disciplined investment decision-making process, and a culture unified around core investment beliefs. Investment results would stem from implementing the following values: (1) invest for the long term; (2) invest in people; (3) build a high-performance culture with accountability and responsibility; (4) be risk managers; (5) allocate wisely; (6) costs matter; (7) diversify with care and act with clarity; (8) sustainability impacts investments; (9) collaborate widely; and (10) innovation counts.

Regent Makarechian expressed appreciation for Mr. Bachher's presentation. He asked if the University had officially lowered its actuarial rate of return, noting that the California Public Employees' Retirement System and the California State Teachers' Retirement System had announced very recently that they would lower their actuarial rates of return. If UC lowered its rate, the University would have to contribute more to UCRP. Mr. Brostrom responded that the Regents would consider action items the following day to reduce UCRP's actuarial rate of return from 7.5 percent to 7.25 percent, and to lower the inflation assumption from 3.5 percent to three percent. There would also be changes to the mortality table based on an experience study of UCRP. The cumulative effect of these changes would be a $2 billion increase in UCRP's unfunded liability. Regent Makarechian commented that the Committee on Investments and the Investment Advisory Group were examples of effective governance and delegation of authority within specified parameters.

Regent Blum also complimented Mr. Bachher on his presentation and on his efforts to reach out to UC campuses regarding their investment and real estate projects.

Chairman Lozano expressed appreciation of Mr. Bachher's work and his efforts to leverage the balance sheet of the Office of the CIO for the benefit of the overall University system, for example by optimizing returns of the working capital portfolios, showing that the Office of the CIO could be an additional resource for the University. Mr. Bachher credited the staff at the Office of the CIO. He acknowledged that the Office of the CIO had benefited greatly from the tremendous intellectual talent at the University and emphasized the obligation of his office to assist the larger University. He encouraged UC campus chancellors and other leadership to explore collaborative financial or capital opportunities with his office.

Regent Reiss congratulated Mr. Bachher on his presentation and his efforts in sustainable investing.

Chancellor Yang thanked Mr. Bachher for reaching out to the UC campuses.

Regent Oved expressed appreciation for Mr. Bachher's leadership and inclusiveness in dealing with students and other UC stakeholders.

Committee Vice Chair Sherman congratulated Mr. Bachher on his office's value-added investment returns above benchmark.

The meeting adjourned at 12:55 p.m.

Attest:

Secretary and Chief of Staff