The Regents of the University of California

COMMITTEE ON INVESTMENTS
INVESTMENT ADVISORY GROUP
February 26, 2016

The Committee on Investments met on the above date by teleconference at the following locations: Plaza Room, De Neve Plaza, Los Angeles campus; and 1111 Broadway, 21st Floor, Oakland.

Members present: Representing the Committee on Investments: Regents De La Peña, Kieffer, Makarechian, Oved, Sherman, and Wachter; Advisory Members Hare and Ramirez; Staff Advisor Richmond

Representing the Investment Advisory Group: Members Crane, Lehmann, and Samuels, and Consultant Klosterman

In attendance: Faculty Representative Chalfant, Secretary and Chief of Staff Shaw, General Counsel Robinson, Chief Investment Officer Bachher, and Recording Secretary McCarthy

The meeting convened at 1:30 p.m. with Committee Chair Wachter presiding.

1. **PUBLIC COMMENT**

The following persons addressed the Committee concerning the items noted.

A. Mr. Todd Lu, UCLA student and member of Fossil Free UCLA, spoke about the urgent need for divestment from the fossil fuel industry, since the science about climate change was clear. He cited details of examples of the effects of climate change, including increases in temperature and levels of atmospheric carbon dioxide, drought, and destructive wildfires, demonstrating that global warming required a swift response. Mr. Lu asserted that the fossil fuel industry perpetuates social and economic injustices, as well as environmental degradation.

Mr. Lu stated that the fossil fuel industry was incompatible with a just and sustainable future. Global leaders and governments have agreed that global warming must be kept under two degrees Celsius, but the fossil fuel industry intended to burn fuel that would lead to warming five times that limit. The Paris Conference of Parties 21 agreement set out an even more conservative goal, to keep global warming under 1.5 degrees Celsius. The United Nations Intergovernmental Panel on Climate Change concluded that a reduction in carbon emissions must be achieved in just six years in order to avoid major climate disaster.

UC's current investment in oil and gas companies represented a denial of climate science and contradicted the University's sustainability initiatives, such as achieving carbon neutrality and the environmental, social and governance investment framework approved by the Regents in September 2014. Fossil fuel divestment would shift the University's investments toward more sustainable ones. The University's selling its coal and tar sands investments signaled to other institutions that those industries were no longer wise investments. Divesting from the top 200 fossil fuel companies would have the same effect.

B. Ms. Minh Tran, UCLA student and member of Fossil Free UCLA, asserted that there was a low financial risk in divesting from General Endowment Pool (GEP) investments in the fossil fuel industry. According to a report by the Impacts Asset Management Group, returns for the past five years were nearly identical between the MSCI World Index and a portfolio without holdings in fossil fuel companies. Holding such investments in the GEP could actually threaten returns. She stated that Deloitte had predicted that one-third of oil and gas producers were likely to go bankrupt in the current year. Current fossil fuel assets carry a great risk of being devalued once political legislation restricted extraction and burning of fossil fuels.

Ms. Tran urged the Committee to recommend that the Regents divest from the fossil fuel industry. She asked the University to freeze immediately new investments in the top 200 fossil fuel companies' corporate stocks and bonds, ranked by carbon content of their reported and estimated reserves; develop and implement a plan within five years to divest the GEP of these assets; reinvest that capital in real climate solutions to address the threats presented by climate change holistically.

Ms. Tran noted that the UC community had called for fossil fuel divestment. Resolutions in support of divestment had been passed by student representative bodies across all nine undergraduate UC campuses. Academic Senate resolutions had been recently proposed or passed at four UC campuses; distinguished UC faculty had called on the Regents to divest. Refusing to divest would signal to the world that UC believed fossil fuels were an acceptable energy source, compatible with UC values of sustainability, even though these investments contradict foundational climate change research spearheaded by UC faculty and researchers.

C. Ms. Janay Williams, UCLA fourth-year student and member of the central committee of the Afrikan Black Coalition, discussed the private prison industry and Wells Fargo. She stated that private prisons disproportionately affect black and brown youth, who comprise 61 percent of California's population, yet comprise 75 percent of California's public prison population, and 89 percent of the for-profit prison population. She asserted that private prison corporations use contractual provisions to target young, healthy, and thus more profitable inmates, who tend to be people of color because of drastic changes in prison demographics.

Over the past 30 years, more than 20 prisons have been built in California, but only two UC campuses and one California State University campus.

Ms. Williams stated that Wells Fargo was a major lender to the Corrections Corporation of America (CCA), acting as a syndication agent and issuing lender to CCA's $900 million line of credit. In addition, as of its latest filing with the Securities and Exchange Commission, Wells Fargo had significantly increased its investment in CCA to 1.08 million shares valued at $36.6 million in 2014. Wells Fargo profited both as a lender and an investor. Ms. Williams stated that private prisons rely on a model that maximizes profits through minimum occupancy requirements, lobbying for incarceration, and minimizing expenses by using a poorly trained and compensated staff, and denying of medical care to inmates.

Noting that many socially responsible investment experts exclude private prison companies from their portfolios, Ms. Williams urged the Regents to terminate their financial relationship with Wells Fargo until it cuts its ties completely with the private prison industry.

D. Ms. Kamilah Moore, UCLA alumna, law student at Columbia University, and southern California field organizer of the Afrikan Black Coalition, reviewed the campaign started in 2013 for divestment from the private prison industry. Initial research had been conducted by UC graduates and undergraduate researchers and organizational partners. Student governments at UC Berkeley, UC Santa Barbara, and UCLA passed resolutions calling for UC divestment from private prison corporations and corporations that conduct business with them. She stated that UC students in Afrikan/Black Student Unions voted unanimously to organize around the issue of divestment from private prisons. Subsequently, UC announced plans to sell its shares of CCA, the GEO Group, Inc., and G4S Security Services.

Ms. Moore stated that, as of November 22, 2015, UC invested $425 million in Wells Fargo, which she said was one of the largest financiers of private prison corporations. In addition, Wells Fargo had a history of predatory lending, discriminating against black and Latino clients. In 2012, Wells Fargo paid a $175 million settlement to resolve claims of discriminatory lending at higher interest rates to black and Latino borrowers. Ms. Moore stated that, as of February 2016, Wells Fargo had agreed to a $1.2 billion settlement to resolve a suit alleging reckless mortgage underwriting and fraudulent loan certification for thousands of Federal Housing Administration-insured loans that ultimately defaulted.

Ms. Moore urged the Committee to establish an investment committee for socially responsible investing. UC was the first public university to sell its shares in private prison corporations.

E. Ms. Amanda Aguilar Shank, with the national private prison divestment campaign Enlace, said that her sister was serving a ten-year prison sentence under laws for which the private prison industry lobbied. She commented that Portland, Oregon's

Socially Responsible Investments Committee voted unanimously to recommend that Portland divest from holdings in Wells Fargo because of its financial support of the private prison industry. She urged UC to divest from its holdings in Wells Fargo.

F. Mr**.** Terron Wilkerson, who introduced himself as Kwesi, alumnus of UC Santa Barbara and executive administrator of the Afrikan Black Coalition, commented that he is involved with the campaign to divest from the private prison industry because of a personal commitment. He expressed pride in being a UC graduate and expressed his view that it was inappropriate for the University to invest in the re-enslavement of his people.

G. A UC Berkeley undergraduate expressed her view that the private prison industry was a continuation of enslavement and exploitation of black people. She stated that it was hypocritical for the University as a public center of higher education to be involved in exploiting black people.

H. Mr. David Turner, UC Berkeley Ph.D. student, commented that at times in history corporations have helped to support what were later recognized as horrible human rights violations. UC should be on the right side of history and divest from Wells Fargo because it supports the private prison industry.

I. A UC Berkeley student expressed his view that Wells Fargo was a racist institution that benefited from slavery and was contributing to poverty and modern enslavement. He stated that UC tuition funds were being used to lobby politicians to implement stricter laws that would benefit private prisons.

J. Mr. Yoel Haile, UC Berkeley master’s degree student and political director of the Afrikan Black Coalition, stated that it was unconscionable for UC to invest in Wells Fargo, which he said had a record of discriminatory lending practices and financial support of private prisons. He expressed appreciation for UC’s decision to sell its holdings in private prison companies. He suggested that UC hold discussions with Wells Fargo to discourage it from financially supporting the private prison industry.

K. A California State University, Los Angeles Ph.D. student, said she spoke on behalf of the California Student Union, and urged the committee to divest from the private prison industry and Wells Fargo.

L. Mr. Dieudonne Brou, UCLA student, stated that he was a product of the school-to-prison pipeline and had been imprisoned when he was 18 years old. He urged the Committee to divest from Wells Fargo because of its financial support for the private prison industry.

2. APPROVAL OF MINUTES OF PREVIOUS MEETING

Upon motion duly made and seconded, the minutes of the meetings of September 9, 2015 and September 16, 2015 were approved, Regents De La Peña, Kieffer, Makarechian, Oved, Sherman, and Wachter voting “aye.”[1]

3. STUDENT ENGAGEMENT IN INVESTMENTS

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

Regent Oved thanked the student presenters who spoke during the public comment period. Both Fossil Free UC and the Afrikan Black Coalition were groups of students with campaigns that they wished to bring to the attention of the Committee. Staff Advisor Richmond expressed appreciation for the students’ presentations and urged the Committee to show leadership in considering the students’ campaigns.

Regent-designate Ramirez expressed appreciation for the student presentations.

Regent Makarechian asked for confirmation that the University’s investment in Wells Fargo was not a direct investment. Chief Investment Officer Bachher agreed that UC’s holdings in Wells Fargo were through external managers who were invested in Wells Fargo or were through market exposure rather than direct investments.

Regent Oved commented that the Afrikan Black Coalition had requested information about the potential financial implications of the University’s selling its Wells Fargo holdings and asked if it were possible to supply this information. Mr. Bachher said it would be possible for his office to study that and bring information back to the Committee.

Regent Oved asked about the feasibility of responding to Fossil Free UC’s requests that the Committee develop a five-year plan to freeze UC investment in the fossil fuel industry, implement a negative screen for the top 194 companies that are fossil-fuel based, and identify other investment alternatives that address climate risk and sustainability. Committee Chair Wachter commented that the Committee had encouraged student involvement during his tenure as Committee Chair. Although considerations of divestment were difficult for many reasons, much progress had been made in sustainable investing, such as setting aside funds for investment in sustainable solutions, including consideration of an environmental, social, and governance framework for all UC investing, and the University’s taking a leadership role in sustainable investing. He noted that the markets themselves had responded to issues of sustainability. He gave credit to students involved in Fossil Free UC for their leadership.

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[1] Roll call vote required by the Bagley-Keene Open Meeting Act [Government Code §11123(b)(1)(D)] for all meetings held by teleconference.

Mr. Bachher agreed that the students' presentations were very articulate, noting the importance of constructive interaction. He expressed pride in the time devoted by his office in consideration of environmental responsibility, social issues, and good corporate governance as it relates to investment decision-making, while recognizing the fiduciary responsibility to maximize returns. These considerations must be made with a broader set of tools than divestment. He referred to his office's decisions to sell holdings in tar sands, coal companies, and private prisons after thoughtful analysis.

Investment Advisory Group member Samuels added that former Governor Schwarzenegger had proposed an amendment to the California Constitution to limit State spending on prisons and increase spending on UC, demonstrating that these issues have been linked for some time. Across the nation, many states were attempting to reduce their prison populations, some by changing sentencing laws, because prison spending had become too large a portion of state budgets. Concerns about the private prison industry had become both an economic and moral issue.

Mr. Bachher expressed his view that Mr. Samuels' comments were accurate and were among the economic reasons his office had decided to sell its holdings in private prison companies.

Regent Oved expressed appreciation for the attention of the Committee to these issues of concern to the presenting UC student groups.

Investment Advisory Group consultant Lehmann agreed with Regent Makarechian's earlier comment, noting that there was a big difference between owning Wells Fargo stock directly and having holdings with investment managers who have small parts of their portfolios invested in Wells Fargo. He said information about UC's holdings in Wells Fargo should include the proportions of these different types of investments.

4. **UPDATE ON INVESTMENT PERFORMANCE FOR PERIODS ENDING DECEMBER 31, 2015**

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

Committee Chair Wachter briefly introduced this discussion of investment performance as of December 31, 2015. Chief Investment Officer Bachher introduced members of the Office of the CIO investment team to provide background information and strategies guiding investments. He referred to geopolitical and liquidity risks that had heightened in importance, particularly implications of recent events in the oil and energy markets and their effect on liquidity.

Senior Advisor Amy Jaffe discussed long-term structural changes of the past year in the oil and energy industry and their implications. For the past 30 years, the oil and gas industry functioned on the operating principles that future oil demand would rise indefinitely as new nations joined the industrial world, and that resources would become depleted, leaving the United States increasingly dependent on Middle East resources. These principles had implications for how central banks set monetary policy, how the Organization of the Petroleum Exporting Countries set its strategies, for political leaders, and for sovereign wealth funds. However, during the past 12 months, it had become clear that everything had to be reassessed as the industry had undergone a permanent structural change. Technological advances, including shale oil production and other unconventional resources, had resulted in the availability of much more varied oil and natural gas resources at lower prices. These advances had allowed increased energy-efficiency technologies that would have a tremendous impact. The Paris Climate accords established the possibility that major world economies, including China and India, might pursue a real effort to move away from oil and gas. The combination of these factors, along with the troubles in China’s economy, was creating a long-term strategic oil and gas dislocation that would have large implications. Short-term factors such as volatility, geopolitical tail risk, the immediate pressure of over-supply of inventory would eventually be resolved, but, even if prices rebounded somewhat, these long-term factors would still exist and would set a new framework.

Ms. Jaffe discussed how the changes in the oil and gas industry would affect oil-based sovereign wealth funds, with $5 trillion in holdings worldwide. Such funds had been the top investors in instruments such as U.S. Treasury bonds, global infrastructure, and global equity markets, but would have to reevaluate their entire strategies based on a changed world order. Rather than providing liquidity, these funds could come to the market selling assets, liquidating Treasury bonds, and as borrowers, which would change the dynamics of liquidity and risk profile in the market over time.

Mr. Bachher summarized that a large pool of capital in the world was becoming a liquidity demander as opposed to a provider of liquidity, and asked Managing Director of Risk Management Richard Bookstaber to clarify the meaning of liquidity risk. Mr. Bookstaber explained that liquidity demand meant that a party has an asset to sell and needs to find someone on the other side of the trade; liquidity supply meant the party was willing to take the other side of the trade. A situation in which an increasing number of parties need to sell assets, thus increasing liquidity demand, would cause prices to decrease more quickly. The 2008 financial crisis involved excessive amounts of leverage, which led to increased bank regulation of the amounts of leverage banks could have and their ability to trade on their own accounts. This regulation had a negative effect on liquidity, since banks would have a reduced capacity or willingness to take on inventory when other parties needed to sell assets; thus a key source of liquidity supply had been reduced. He agreed with Ms. Jaffe’s assessment of reduction in sovereign wealth funds’ ability to supply liquidity. Some sovereign wealth funds, such as China, were also affected by currency factors. In addition, central banks, typically liquidity providers of last resort, may be at capacity as liquidity providers. An increase in demand for liquidity by parties needing to sell assets could be met with a dearth of liquidity providers and could result in a drop in prices greater than had been anticipated. In fact, former liquidity providers could be in a position of having to sell assets. Mr. Bookstaber observed that the lack of liquidity could amplify and accelerate the cascading effects of any market dislocation. This liquidity risk was difficult to anticipate or measure.

Regent Kieffer commented on recent volatility in the stock market, but said that in general markets did not seem to be anticipating this liquidity risk. He asked if there were countervailing market forces that would balance the liquidity risk. Mr. Bookstaber responded that any market dislocation would have to be addressed from the supply side, by putting measures in place so that those with available capital would be more willing to supply it to the market. Regent Kieffer asked why the liquidity situation was not already reflected in the market. Mr. Bachher agreed that current market prices did not yet reflect this risk assessment, so it would be an inopportune time for additional equity investment.

Managing Director Edmond Fong commented that world markets were still dependent on quantitative easing and other stimulus measures, even though eight years had passed since the 2008 financial crisis. Markets might have taken for granted the permanence of these measures and the effect of their unwinding was uncertain. Mr. Fong also expressed concern about the maturation of the business cycle. Finding value in the current market was difficult. As the importance of central banks and government policy to the economy has grown, the risks of policy missteps would increase. Demand had also been taken for granted. The collapse in commodity prices had exposed cracks in the system, such as the misappropriation of capital in this era of inexpensive money. He anticipated further headwinds in industry going forward, encouraging future market volatility that could be magnified by the liquidity issues discussed earlier. The U.S. economy had been a bright spot, although U.S. earnings per share growth had been supported in recent years by cost-cutting measures, share buy-backs, and record mergers and acquisitions. In summary, Mr. Fong stated that his office was less optimistic about the economy and would be more selective in its investments.

Regent Makarechian observed that a few years prior when oil prices were much higher, the U.S. shifted almost $1 billion a day to oil-producing countries to pay for oil, and oil-producing countries were providing the market liquidity discussed previously. Currently, the shift in the oil and gas industry had resulted in U.S. consumers' having more disposable income, which should result in more spending on consumer goods. Consumer spending would increase the liquidity of U.S. companies such as Apple, which could then buy U.S. Treasury bonds. Ms. Jaffe agreed that it had been anticipated that lower gas prices would increase U.S. consumer spending and hold up the economy; however, that had not happened. The effect of relatively small increases in consumers' disposable income could not compete with the large amounts of previously available liquidity from sovereign wealth funds. Savings from lower gas prices were dispersed and were not necessarily being spent on consumer goods. Regent Makarechian commented that long-term effects could be more beneficial. Effects of lower gas prices on sovereign funds' prior commitments could be a major concern worldwide. Mr. Bachher agreed that sovereign funds that have oil revenues and sovereign funds with currency reserves could involve $10 trillion. Many managers anticipate a rebound in energy prices.

Regent Kieffer asked how a more optimistic analysis of the economic outlook would differ from this assessment. Ms. Jaffe commented that some believe that pockets of development in Asian economies such as Thailand, Vietnam, Malaysia, and Indonesia would support markets. She expressed her view that, while these economies could develop, it would not be the same as China's bringing millions of its citizens out of poverty. Regarding the oil industry, Ms. Jaffe expressed her view that, under current circumstances, Saudi Arabia did not intend to cut its oil production in an effort to boost prices.

Investment Advisory Group consultant Klosterman expressed his view that low returns on Treasury bills for an extended period had had an effect on equity markets.

Investment Advisory Group consultant Lehmann commented that the beliefs of the Office of the CIO about the energy sector would eventually affect its allocation to that sector. He expressed his view that liquidity risk would come into play only if many other investors were making similar moves at the same time. If the view that there would be a structural change in the energy market were strongly held, the question was when would be the best time to make that move.

Regent Makarechian asked about the balance sheet of the Federal Reserve Board (Fed). Senior Portfolio Manager Steven Sterman responded that during that past eight years, the Fed had accumulated a $4 trillion balance sheet. He expressed his view that the Fed was currently in the position of having to retain that balance sheet and was attempting to normalize interest rates gradually, to allow room to respond should a recession occur in a few years. He did not anticipate the Fed's reducing its balance sheet for a long time. The Fed was currently reinvesting its cash flow and could increase its balance sheet through additional quantitative easing should a recession occur, rather than establish negative interest rates as some other central banks had done.

Mr. Bachher commented that, despite this overall scenario, pockets of opportunity for investment existed with some opportunities being more suited to either the UC Retirement Plan (UCRP) or the General Endowment Pool (GEP). For example, even the role of fixed income investments was different in the UCRP and the GEP. He emphasized that his focus during the past two years had been to manage the UCRP, GEP, and working capital pools differently based on their risk and return objectives. His office had been reviewing the asset allocations of these products and had engaged consultants to evaluate how UC investments had performed for the past 20 years relative to peers. For example, in the GEP, a comparison with institutions with similar asset allocations showed that UC's performance was at the median. The difference in investment performance among the best- and worst-performing endowments among the top 20 endowments in the United States could be in implementation, or how the funds were invested within an asset class. For example, a similar 45 percent allocation to public equities could yield different results if that allocation were invested with 80 different managers versus ten to 12 managers. Mr. Bachher concluded that his office's implementation needed to be simplified and changed, which had been his focus during the past two years. For example, two years prior, there were close to 500 individual investments in the GEP and the UCRP; by June 30, 2016 that number would be reduced to roughly 150. This simplifying of the holdings was part of an effort to aggressively reduce costs and would also provide a cleaner backdrop against which to evaluate new opportunities. Paying for active management should yield value; the balance of the portfolio could be passively invested.

Mr. Bachher reported that, as of December 31, 2015, the UC Entity held $95.7 billion, and $92.5 billion as of January 30, 2016, down from $98.2 billion as of June 30, 2015. Mr. Bachher discussed asset allocation in the GEP. Given higher market valuations and the possibility of liquidity risk, the Office of the CIO had been selling assets at attractive valuations and reinvesting that capital. If attractive buying opportunities were not found, the capital was held in the Short Term Investment Pool (STIP). Allocations to public equities had been reduced because of the market views discussed earlier; the GEP allocation to fixed income had been reduced to 11 percent and could be reduced further. The portion of the fixed income portfolio needed to fund its payout could be invested in Treasury bonds, and the balance in other opportunities. Allocation to private equity had been increased as unique opportunities had arisen during the past year.

Mr. Fong reviewed GEP returns for the past six-month and one-year periods. Returns of the past six months had been negative, while one-year returns were positive. In the first half of 2015, the Standard and Poor's 500 (S&P500) Index rose about 1.2 percent; MSCI ACWI Index rose 3.5 percent; emerging markets rose 5.6 percent. However, in the second half of 2015, the S&P500 was flat, the MSCI ACWI Index fell about five percent, and the MSCI Emerging Markets Index fell 10.8 percent. That downward trend accelerated in January 2016, with the GEP falling about 6.2 percent. Mr. Fong said public equities fell approximately 12.7 percent and absolute return fell 6.3 percent for the fiscal year to date through January 2016. Private equity and real estate helped add value to absolute returns. In January, a major shift in risk sentiment was seen. Volatility increased during January. Mr. Fong noted that there was a high downside correlation among stocks, making the market challenging for active managers. GEP returns were approximately two percent below the benchmark for the fiscal year to date through January. Mr. Bachher commented that equity returns would have to increase 12 to 15 percent by June 30, the end of the fiscal year, to recover losses in the first half of the fiscal year. With 45 percent of its assets invested in equities, the GEP could have a negative absolute return for the fiscal year.

Mr. Fong observed that hedge funds were not an asset class, but rather were an amalgam of various strategies and opportunities. The decision to invest in a hedge fund would depend on that specific opportunity. He expressed his view that there was validity to the common criticism of hedge funds costs. Going forward, his office would align itself more with partners, review the underlying strategies, and reconsider whether the opportunity offered an advantage justifying its cost.

Regent Sherman asked what portions of the GEP were actively and passively managed. Mr. Bachher responded that roughly 70 to 80 percent was actively managed and 20 to 30 percent passively managed. There were roughly 20, predominantly active, managers in the public equity portfolio. The absolute return portfolio and all illiquid investments were actively managed.

Regent Kieffer asked how comparator endowments have fared. Mr. Bachher responded that he did not have this information currently. Mr. Bachher noted that returns on private equity are lagged. Regent Kieffer asked if such information was commonly shared among endowment investment professionals. Mr. Bachher said that normally happened once a year, after the end of the fiscal year; quarterly results were generally not shared. Committee Chair Wachter summarized that the market had been terrible and hedge funds also had not done well. He doubted that many endowments had positive returns for this period. Regent Sherman pointed out that the management of the Office of the CIO had added value to returns over benchmarks for every period of time shown from 20 years to six months.

Regent Sherman asked how the Office of the CIO determined which external managers to eliminate and which to keep. Mr. Bachher stated that he would report on this at a future meeting. He commented that two years prior the Office of the CIO had 80 external public equity managers; it currently had 50. The GEP previously had 32 hedge funds, which would likely be reduced to fewer than ten. Regent Sherman asked if the funds from the liquidated holdings were invested in the funds that were retained, since the allocation remained the same. Mr. Bachher answered in the affirmative. Funds were added to those managers that had been performing well and new managers were sought, sometimes as co-investors, and with a favorable fee structure. Regent Sherman stated that it was important to gain added value from external managers, given their cost. Mr. Bachher commented that, for example, the Total Return Investment Pool (TRIP) had $1 billion allocated to the absolute return asset class, invested in roughly six hedge funds with high fee structures. There may be other products that would be available at lower cost, but could provide the desired market exposure, return profile, and diversification. His office would be reviewing these TRIP holdings. It would be hard to actively manage U.S. large-cap equities, so passive implementation would be appropriate there. The investment guidelines indicated that the public equity portfolio should have a beta of one. To achieve that beta, the Office of the CIO had 80 public equity managers, but that would come with a high cost structure to achieve basically only market returns.

Regent Makarechian asked if there were fees for co-investments. Mr. Bachher responded that his office tended not to pay fees for co-investments in private equity, but would sometimes pay fees for co-investments in other asset classes.

Mr. Lehmann commented that hedge funds vary; some provide a market-making role and could provide a hedge against a downturn, but not against a liquidity downturn. Mr. Fong agreed, stating that his office was avoiding hedge funds with market-making strategies. Mr. Bachher added that hedge funds can have contractual liquidity issues, such as three-year lock-ups, during which investors cannot sell shares.

Turning to the UCRP, Mr. Bachher said its asset allocation contains 22 percent fixed income. Mr. Sterman discussed the current bond market, particularly the U.S. bond market, where 98 percent of the UCRP fixed income was invested. Mr. Sterman recalled that in early 2015 he had anticipated that U.S. growth would continue at a moderate pace, that strength in the labor market and a gradual uptick in inflation would allow the Federal

Reserve to start increasing interest rates toward normalization. This would result in higher-yielding Treasury bonds and corporate bonds performing better because of the spread. This scenario started to play out in the first half of 2015, with interest rates on ten-year bonds at almost 2.25 percent. As a result, the fixed income portfolio was underweight Treasury bonds, overweight corporate bonds, and with an overall shorter duration in anticipation of interest rates' increasing. However, in the beginning of the fiscal year, concerns about China and global growth resulted in heightened volatility and a flight to quality. Treasury bonds rallied, yields went lower, and credit spreads widened. So for the fiscal year to date, UC's fixed income portfolio has underperformed its benchmark. The portfolio's overweight in corporate bonds detracted from performance. For the year to date, UCRP had been affected by the combination of negative performance in the global equity markets and underperformance relative to moderate positive returns in fixed income policy benchmarks.

Going forward, Mr. Sterman anticipated continued slow growth in the U.S. Current data on inflation and the labor market would create a conundrum for the Fed, based on concern about global growth. Other central banks were using quantitative easing and negative interest rates. Yet the mandate of the Fed is to consider increasing interest rates. While the Fed had anticipated increasing interest rates four times in the current year, Mr. Sterman did not anticipate that it would in the current environment. Mr. Sterman anticipated that interest rates would stay low for a long time. Global rates are very low, if not negative, and the U.S. Treasury market is still attracting buyers from around the world.

Mr. Klosterman asked about the fixed income portfolio's duration. Mr. Sterman responded that the policy benchmark's duration was 5.5 years; the portfolio's benchmark was five years. Mr. Klosterman asked if that would change. Mr. Sterman replied that his office would seek opportunities in the Treasury market, if rates moved slightly higher.

Mr. Sterman discussed the working capital portfolios. The combined STIP and TRIP portfolios totaled $14.5 billion. At the beginning of the fiscal year, the TRIP portfolio's new policy asset allocation of 50 percent fixed income, 35 percent equity, and 15 percent absolute return was implemented, reducing the portfolio's risk. The portfolio was underweight absolute return and overweight cash. The Office of the CIO was seeking a more effective, lower-cost implementation of its absolute return allocation.

Staff of the Office of the CIO visited UC campuses to discuss optimizing the balance in campus funds between STIP and TRIP. As a result, in September 2015, a transfer of $1.2 billion was made from STIP to TRIP. TRIP's equity portfolio was rationalized to a low-cost, passive implementation. Along with TRIP's new asset allocation, ten percent would be invested in private growth and income equities, of which five percent was currently invested. A good portion of that amount is invested in mature, income-producing real estate assets. That portion is also invested in mature private equity funds as well as some other direct investments, including a consumer finance transaction and a direct real estate purchase in Santa Barbara.

Overall returns for the year were negative, driven by factors in global equity markets discussed previously. Fixed income returns were slightly positive, but lagged the benchmark because of the core fixed income duration stance and the overweight to credit.

Mr. Sterman commented that a big upswing in public equities would be needed in the rest of the fiscal year to yield a positive return for the year. He noted the benefits of reducing risk in the portfolio early in the fiscal year, which limited the damage. He expressed his view that the TRIP asset allocation was appropriate and would achieve higher returns than STIP over a long period of time.

Mr. Bachher added that the portfolio previously had approximately 25 external public equity managers. That number had been reduced and 35 percent of the portfolio was currently passively invested. He anticipated that costs would be reduced. His office would seek ways to reduce management costs in the absolute return portfolio. In the current low-return environment, costs savings were significant.

Regent Sherman asked about the duration of the fixed income portion of the TRIP portfolio. Mr. Sterman stated that it was similar to the 5.5-year fixed income duration of other products.

Regent Sherman asked Mr. Bachher about his plans to deploy the cash in the portfolio. Mr. Bachher responded that opportunities would present themselves, possibly in direct lending.

Regent Makarechian asked for information about the specific fixed income holdings that comprised each rating group, for instance what sector holdings were rated AAA or BBB. Mr. Bachher responded that he would provide more information about the fixed income portfolio in the next quarterly report, including duration and credit quality. Mr. Sterman commented that the majority of the holdings in the investment grade credit portfolio were rated BBB. He was seeking, particularly in TRIP, to generate higher levels of ongoing income, so that portfolio had an overweight to BBB holdings. TRIP also contained a five-percent allocation to high-yield fixed income, predominantly a mix of B and BB. In core fixed income, about 30 to 35 percent of holdings were in government securities, rated AAA. Another 15 percent were in government agency guaranteed mortgage-backed securities, rated AAA, and 40 to 45 percent in investment-grade securities of which 50 to 60 percent are BBB.

Regent Makarechian asked if the Office of the CIO held any UC securities. Mr. Sterman answered in the negative, explaining that the University was a high-quality issuer and its securities would not have the spread and return characteristics that his office sought.

Regent De La Peña asked if the returns above benchmark included costs. Mr. Bachher responded that the returns were net of fees.

Mr. Sterman commented on the STIP portfolio. The Fed raised interest rates in December 2015, and the portfolio was earning 25 to 35 basis points more in commercial paper than it had been. His office continued to concentrate on government securities with short duration. For more than a year, his office had not purchased corporate bonds in the STIP portfolio. The credit quality in STIP would increase as its corporate bonds mature. More risk would be taken in TRIP.

Mr. Bachher expressed his view that there would be more bad economic news to come, but that climate had not yet been translated into current valuations, leading him to be cautious about investments in stocks, bonds, and illiquid investments. The differentiation between the asset allocation of UCRP and the GEP led to higher returns in the GEP, which had a larger allocation to alternative investments. The individual investments in the two products were largely similar. Over the past two years, his team had reviewed how the portfolios were invested to consider if the holdings match the purposes of the products. The portfolios were beginning to be more differentiated. Returns would begin to be more differentiated because of the difference in the underlying holdings. In the current market, security selection would be very important.

5. **AMENDMENT OF INVESTMENT POLICY STATEMENT FOR UNIVERSITY OF CALIFORNIA GENERAL ENDOWMENT POOL**

The Chief Investment Officer, in consultation with Mercer Investment Consulting, Inc., recommended that the Committee on Investments recommend that the Regents Policy 6102: Investment Policy Statement for the General Endowment Pool be amended as shown in Attachment 1.

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

For discussion see item 6, below.

6. **AMENDMENT OF INVESTMENT POLICY STATEMENT FOR UNIVERSITY OF CALIFORNIA RETIREMENT PLAN**

The Chief Investment Officer, in consultation with Mercer Investment Consulting, Inc., recommended that the Committee on Investments recommend that the Regents Policy 6101: Investment Policy Statement for University of California Retirement Plan be amended as shown in Attachment 2.

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

Chief Investment Officer (CIO) Bachher stated that the Investment Policy Statements were the governance guidelines set by the Committee on Investments and the Board. Mr. Bachher had reviewed the investment policies to ensure that they reflect the way the Office of the CIO was investing. Mr. Bachher explained that, since the General Endowment Pool (GEP) and the UC Retirement Plan (UCRP) were becoming more differentiated, the Appendices currently common to both would be moved to each Policy

Statement, so each would be a stand-alone, complete document. Another change was that guidelines that had been repeated several times throughout the each section of the policies were put in one section, to shorten and simplify the policies.

Investment Officer Susan Ardeshir reviewed the recommended changes to the UCRP and GEP Investment Policy Statements. Mr. Bachher commented that the section on Principal Risks that had been in the section on Investment Goals, Key Responsibilities, and Philosophy, would be moved to Appendix 2, Risk Management Policy. Section 5 on Asset Class and Manager Guidelines was moved to Appendix 7, Asset Class and Manager Investment Guidelines. Strategic asset allocation would no longer show the current allocation and long-term target, but would show only the long-term target allocation. Opportunistic Equity and Cross Asset Classes would be removed since they no longer existed in the portfolios.

Ms. Ardeshir reviewed proposed changes to Appendix 1 of the GEP Investment Policy. The Global Equity asset class would be eliminated. Mr. Bachher noted that Appendix 7D, Asset Class and Manager Investment Guidelines for Global Equities, would be retained, as it could be used in the future. Ms. Ardeshir noted that the former ten percent allocation to Opportunistic Equity would be redistributed to U.S. Equity, Developed Non-U.S. Equity, and Emerging Market Equity. The former five percent allocation to the Cross Asset Class would be redistributed to Private Equity and Real Estate. Mr. Bachher observed that UC’s allocation to Private Equity was about half of that of its comparators’; UC’s comparators also had a much higher allocation to Real Estate.

Ms. Ardeshir stated that another proposed change to the GEP Investment Policy was a change to the benchmark for the Absolute Return asset class. Mr. Bachher explained that the Absolute Return asset class had historically been invested in long/short investment strategies and a collection of other strategies such as event-driven, global macro, and arbitrage. Jay Love of Mercer Investment Consulting, Inc. stated that the HFRX Market Directional Index, which had been 50 percent of the Absolute Return benchmark, would be eliminated, to achieve a higher correlation to the broader market strategies in the hedge fund universe. The Office of the CIO was moving away from the siloed approach of creating a hedge fund portfolio with return enhancement plus diversifying strategies, to one focusing exclusively on opportunities and strategies less correlated with stocks and bonds. Exposures in long/short equities and equity-related strategies had been transitioned to the public equity portfolio, so that equity risks could be more holistically managed in one portfolio rather than through oversight of two separate portfolios.

Regent Sherman asked that information be provided about the asset class benchmarks’ correlations to the S&P 500 index or to another benchmark, to help in understanding the relationship between possible market changes and portfolio changes. Mr. Bachher said he would provide that information.

Investment Advisory Group member Klosterman asked how a change in benchmarks would affect reporting of earlier returns. Mr. Bachher stated the new benchmarks would apply only to future returns. Any change in benchmark would be made at the beginning of the fiscal year.

Committee Chair Wachter said that, in view of the proposed changes to the Investment Policy Statements, the Office of the CIO should provide the Committee with a report on its risk policy and risk tolerance, whether it had increased or decreased since last discussed with the Committee, and how the proposed policy changes would affect the portfolio's risk.

Mr. Bachher observed that the actual portfolio was the benchmark for the Private Equity and Real Assets asset classes. He expressed his view that this should be reviewed. Mr. Love commented that the Investment Policies should be further updated to reflect the new management of the Office of the CIO. He expressed his view that its risk budgeting component may not function as intended.

Committee Chair Wachter asked if Opportunistic Equity had been a public equity asset class. Ms. Ardeshir commented that Opportunistic Equity was considered an alternative investment, but in the Total Return Investment Pool it was considered a public equity class and the underlying investments were in public equity.

Regent Oved asked how tracking errors were considered. Ms. Ardeshir said tracking errors were described by standard deviation relative to a benchmark.

Investment Advisory Group consultant Lehmann asked about the absolute return benchmark, acknowledging that it was difficult to find a good benchmark for Absolute Return and Private Equity. Mr. Fong agreed that this benchmark was probably flawed.

Ms. Ardeshir discussed proposed changes to the UCRP Investment Policy Statement, which were generally similar to those proposed for the GEP Policy. The prior eight percent long-term target allocation to the Cross Asset Class was distributed pro-rata; the former allocation to Opportunistic Equity and Global Equity was distributed among the equity asset classes. These moves allowed the portfolio to reach its long-term target allocations that had been approved in March 2013. The Proxy Voting Policy was updated to include the Office of the CIO's Sustainable Investment Framework. Mr. Love stated that some general guidelines that had been repeated in every section were moved to a separate section.

Mr. Love discussed recommended changes to the Public Equity Guidelines to reflect the more dynamic approach taken by the current Office of the CIO. Current guidelines specify that the equity asset class Beta would not be significantly different from 1.0, which he said would not allow much flexibility. The recommendation was to allow a Beta between 0.6 and 1.25. Mr. Love expressed his view that the Beta would not go to either of those extremes, but the range would allow flexibility. He explained that a Beta of 1.0 would mean that the portfolio would basically equal the performance of the equity market. Mr. Bachher added that a Beta of 1.0 would mean that the entire portfolio could be passively invested. If the portfolio would be actively managed and with fewer external managers than before, the portfolio would not necessarily duplicate the market at any given time.

The existing Public Equity Guidelines require that aggregate holdings of any one security not exceed 4.9 percent of that security’s outstanding shares. Mr. Love characterized this guideline as reasonable, but commented that, as the number of managers is reduced and fewer managers would hold larger positions, it would be possible that an external manager could hold more than 4.9 percent of the outstanding shares of a company. The recommended change would allow aggregate holdings of any one security up to 7.5 percent of that security’s outstanding shares. Mr. Bachher added that a check on this is that his staff is required to provide him with an issuer list so he knows the securities owned in each portfolio and how much is owned.

Mr. Bachher suggested that these proposed changes be discussed at this meeting and brought back as an action item at the next meeting.

Regent Makarechian asked for clarification of the proposed change to Public Equity and Public Real Estate Guidelines that the aggregate holdings of any one security may not exceed 7.5 percent of that security’s outstanding shares, increased from the existing limit of 4.9 percent. He asked how it was determined that 7.5 percent would be an appropriate limit. Mr. Bachher said he would provide concrete examples of the effects of these limits, and the diversification or concentration of the portfolio at the next meeting, and would provide relevant information to the Committee in advance of the next meeting.

Committee Chair Wachter observed that these limits affect possible concentration of the portfolio. He suggested considering setting different limits for companies with different levels of market capitalization. For example, if a company has a market capitalization of up to a certain amount, UC portfolios could own up to a certain percentage. Owning 7.5 percent of a small-cap company would be very different from owning 7.5 percent of a large-cap company.

Committee Chair Wachter recommended a comprehensive review of the Investment Policy Statements. Mr. Bachher stated that his office’s investment strategy was moving from large pools of diversified managers to smaller sets of managers that he hoped would be more efficient and earn higher returns. This strategy would increase the likelihood of reaching the concentration limits.

Committee Chair Wachter emphasized the significance of changing the Beta of the equity portfolio from 1.0 to an allowable range of 0.6 to 1.25, which would be the equivalent of changing from being like an index fund to allowing discretion by the Office of the CIO to the extent of a hedge fund. He was not necessarily recommending against the change, but pointed out that it would be very significant and should be thoroughly explained and considered.

Regent Sherman asked if managers of the passively invested portion of the portfolio would be subject to concentration limits. Mr. Bachher said they would be excluded.

Mr. Lehmann commented that moving from a Beta of 1.0 could be appropriate since the portfolio would not be managed passively. Widening the range of allowable Beta would permit flexible risk-taking.

Regent Kieffer expressed his view that presentations that help educate the Committee are helpful. Regent Sherman agreed. Committee Chair Wachter complimented Mr. Bachher on his presentations and those of his staff that make the material understandable to non-professionals.

Regent Makarechian thanked Committee Chair Wachter for his 12 years of able service on behalf of the University and its employees.

Committee Chair Wachter thanked the Committee and the Investment Advisory Group for their commitment. He expressed optimism about the future leadership of the Committee and the Office of the CIO, and satisfaction with changes in investment strategy that had been made during his tenure.

The meeting adjourned at 4:30 p.m.

Attest:

Secretary and Chief of Staff