ATTACHMENT

Office of the Treasurer of The Regents

University of California

I-4
Fixed Income Program Review

Committee on Investments/
Investment Advisory Group
February 26, 2013

Fixed Income: Market Overview

--- Credit Yield --- MBS Yield --- Gov't Yield

Fixed Income: Assets Under Management *($millions)*

As of 12/31/2012

Core Fixed Income	UCRP	GEP	403b	STIP	Savings	TRIP	Total
Governments	$1,418	$112	$624	$1,408	$3,817	225	$7,604
Collateralized	1,545	104	673	NA	NA	225	2,547
Credit	1,344	102	584	6,465*	NA	2,029	10,524
Total	4,307	318	1,881	7,873	3,817	2,479	20,675
Non Core Fixed Income							
TIPS	2,963	186	729	0	0	0	3,878
High Yield	1,341	194	0	0	0	449	1,984
Emerging Mkt	1,182	188	0	0	0	0	1,370
Total	$5,486	$568	$729	$0	$0	$449	$7,232
Total Fixed Income	$9,793	$886	$2,610	$7,873	$3,817	$2,928	**$27,907**

* *includes $1.142 million c/p*

Fixed Income Strategy: Core Portfolios

- With Government yields at multi-decade lows, Core portfolios have reduced exposure to the Government sector and increased exposure to the Credit and Collateralized sectors

- That strategy has helped returns as Investment Grade Credit has consistently generated excess return versus Treasuries; looking forward, the scope for further out-performance is limited as the sector yield spread to Treasuries has narrowed sharply

  - Credit now yields 131 bps more than Treasuries vs 217 bps, as of 12/31/2011

- The Collateralized Sector has had robust returns FYTD attributable to non-agency RMBS and CMBS as well as security selection in agency RMBS; as the Credit sector weight is reduced, the proceeds will be reinvested in the Collateral sector

Fixed Income Strategy: Government Sector

- When the Fed begins to tighten monetary conditions, the Government sector will be the most heavily impacted and is likely to deliver negative returns in the -5-10% range
  - Interest rate forwards factor in Fed tightening beginning in late 2014
- This risk is being mitigated in two ways
  - A low weight is assigned to the Government sector within the Core portfolio as a whole
  - The Government sector itself has interest rate and yield curve exposure that will limit our losses in the tightening scenario
- Portfolio yield has been increased by purchasing Government sector spread product
  - REFCORPs
  - GSE subordinated debt

Fixed Income Strategy: Credit Sector

- **Macro view**
  - In Q4 2012, growth drivers shifted: housing and hiring improved while capital expenditures worsened
    - Home prices rose in 2012, home construction added 0.3% to 2012 GDP, and could add up to 1% to 2013 GDP
    - The unemployment rate fell 0.7% to 7.8% during 2012
  - The worst-case scenarios for European markets and economies have been averted, primarily due to ECB support
- **Credit Portfolio now has more cyclical exposure than the benchmark**
  - Large position in the U.S. financial sector, adding some blue chip European banks
    - Attractive spreads balanced by regulatory uncertainty
  - Increased exposure to homebuilders and building material suppliers
  - Reduced weights in healthcare and pharma

Fixed Income Strategy: Collateralized Sector

- **Federal Reserve Board** has engineered the lowest mortgage rates in decades
  - QE III purchases by the Fed in the RMBS market total 70% of total new agency mortgage-backed securities production

- **Housing prices** have bottomed out and the inventory of homes for sale has fallen sharply; 30-year fixed mortgage rates currently average around 3% and have energized new home sales; the evolving market consensus is that after 5 long years of decline, the housing market will materially contribute to 2013 GDP growth

- **With the worst-case scenarios for residential and commercial real estate eliminated,** CMBS and non-agency RMBS have done well; in particular, non-agencies (a 10% portfolio weight) delivered an extraordinary 17% FYTD return

- **Large positions in CMBS and non-agency RMBS** have propelled the Collateralized sector to over 4% of excess return in just 6 months

Fixed Income Strategy: Emerging Markets

- **Macro view**
  - Stronger growth than developed world
  - Improved fundamentals/upward ratings trajectory
  - Dwindling issuance as many countries are paying down borrowings
- **Biggest weights**
  - High yielders: Venezuela, Ukraine
  - Improving credits: Russia, Indonesia, Mexico, Turkey
- **Small or zero weight**
  - Low yielding, high quality countries
    - Brazil, Peru, China, Malaysia
    - Returns will be highly correlated with U.S. Treasuries
  - High yielding (and should be)
    - Argentina
- **Risks**
  - Considerable spread compression to developed markets has already occurred

Fixed Income Strategy: High Yield

- High Yield, using the Merrill Lynch High Yield Cash Pay Index as a proxy, has returned 9.90% per annum for the last 5 years
  – HY returns cannot sustain that pace, expected returns for 2013 are in the 5-7% range
- The longstanding overweight to the sector is slowly being reduced and the idea of using bank loans as a substitute for part of the High Yield allocation is being explored
- Bank loans actually carry less credit risk than most high yield securities since they are senior to other forms of company debt and they are typically secured
- Structured as floating rate obligations, their return improves as interest rates increase whereas fixed rate securities can experience price declines as rates rise

Fixed Income Strategy: STIP and Savings Funds

- **STIP took advantage of attractive spreads on high quality corporate securities early in 2009/2010 and continues to benefit from those investments**

- **Increased precautionary liquidity related to uncertainty on monthly State warrants has reduced yield but the new State budget may improve State of California cash flow and timely receipt of warrants**

- **The Savings Fund (government securities only) was unable to take advantage of the dislocations in the corporate bond market in 2009/2010 but has avoided the excess liquidity hampering STIP**

- **Negotiating the transition to a higher yielding environment is the next challenge for both funds; we are beginning to shorten the average maturity**

Fixed Income: Recent Quarterly Performance

FIXED INCOME	Recent Quarter (%)	Fiscal YTD (%)	One Year (%)	Three Year (%)
UCRP AND GEP TOTAL CORE FIXED INCOME	**0.51**	**3.28**	**5.96**	**6.78**
Policy Benchmark	***0.21***	***1.80***	***4.21***	***6.19***
Variance	***0.29***	***1.48***	***1.75***	***0.59***
UCRP and GEP TOTAL HIGH YIELD	**3.40**	**7.98**	**16.11**	**11.88**
Policy Benchmark	***3.15***	***7.87***	***15.44***	***11.61***
Variance	***0.25***	***0.11***	***0.67***	***0.28***
UCRP GEP EMERGING MARKET DEBT	**3.04**	**9.55**	**16.74**	**11.39**
Policy Benchmark	***3.24***	***9.47***	***16.72***	***11.24***
Variance	***(0.20)***	***0.07***	***0.02***	***0.15***
STIP	**0.61**	**1.24**	**2.43**	**2.52**
Policy Benchmark	***0.06***	***0.10***	***0.21***	***0.38***
Variance	***0.55***	***1.14***	***2.22***	***2.14***

Fixed Income: Benchmarks

Active Total Return Funds
Core UCRP, Core GEP and 403(b): Barclays Capital U.S. Aggregate
TIPS: Barclays Capital TIPS Index
High Yield: Merrill Lynch High Yield Cash Pay Index
Emerging Markets: JP Morgan Emerging Market Bond Index Global Diversified
Income Funds
STIP: Weighted Average of Income Return on Constant Maturity 2-Year U.S. Treasury Note and the Return on U.S. 30-Day Treasury Bills
Savings Fund: Income Return on Constant Maturity 2-Year U.S. Treasury Note
Passive Index Fund
UCRP and GEP Core Index: Barclay Capital U.S. Aggregate

Fixed Income: Personnel Update

Linda Fried, Senior Portfolio Manager-Credit, retired on December 15, 2012, after 30 years of service to the University.

Linda had responsibility for the Core Credit, High Yield and Emerging Market bond portfolios. Those portfolios have consistently added value to UCRP, GEP and the defined contribution plans, a testimony to her talent and hard work. The Office of the Treasurer will miss her contributions.

Steven Sterman has been hired to take over Linda's responsibilities. Steve comes to the University from TIAA-CREF, where he was a Managing Director in Fixed Income. He spent 20 years at TIAA-CREF, with assignments across several fixed income investment functions, including credit research, trading, and portfolio management. Most recently, he had management-level responsibility for Fixed Income trading and Core portfolio management. Mr. Sterman graduated from Brandeis University with a B.A. in economics and the Stern School of Business with a M.B.A. with a concentration in finance.