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Office of the Chief Investment Officer of the Regents

TO MEMBERS OF THE INVESTMENTS SUBCOMMITTEE / INVESTMENT ADVISORY GROUP:

ACTION ITEM

For Meeting of March 14, 2017

GENERAL ENDOWMENT POOL ASSET ALLOCATION REVIEW AND RECOMMENDATIONS

EXECUTIVE SUMMARY

The Chief Investment Officer and investment consultant Cambridge Associates recommend changes to the General Endowment Pool asset allocation.

RECOMMENDATION

The Chief Investment Officer and Cambridge Associates recommend that the Investments Subcommittee approve amendment of Section A of Appendix 1 of the University of California General Endowment Pool Investment Policy Statement as shown in Attachment 1, effective July 1, 2017.

BACKGROUND

1. The analytical framework that the Office of the Chief Investment Officer (CIO) used to evaluate potential policy asset allocations for the General Endowment Pool (GEP) combined several underlying techniques, providing a broader perspective than that which would have been available from any single type of analysis. The underlying techniques included:

    a. Developing the return assumptions, or projections for future returns, for the asset classes that are modeled in this analytical framework are derived in part from a set of long-term, "equilibrium" capital markets assumptions provided by Cambridge Associates and informed by their study of historical capital markets returns. They are intended to represent long-term averages for returns of various asset classes or expectations for asset class returns as though "starting from fair value," as opposed to starting from subjective assessments of current valuations. The Office of the CIO believes that this approach is appropriate for the analysis of long-term strategic policy decisions. The asset classes return assumptions are also informed by expectations for UC's particular approach to implementing investment programs within each asset class.

b. Portfolio return and risk characteristics for candidate portfolios were calculated using mean-variance analysis, with the focus on identifying prospective portfolios with risk characteristics within levels deemed to be tolerable and prudent for the GEP and subject to constraints imposed by practical implementation for private equity and other illiquid asset classes. Note that the selection of the proposed portfolio that was informed by this analysis was not derived from an optimization exercise targeting a specific expected return.

c. Candidate portfolios were also evaluated for their exposures to various sources of systematic risk using multi-factor analysis, providing a more multi-dimensioned view of risk than mean-variance analysis' narrower definition of risk as volatility of returns. Portfolio risk was also characterized in "Reference Portfolio" terms by identifying the hypothetical passively invested stocks-and-bonds portfolio exhibiting equivalent levels of risk (e.g., a basic 60/40 portfolio). The "Reference Portfolio" concept provides a more intuitive measure and description of risk than volatility of returns. It can also assist in evaluating the potential benefits and risks, including changes in exposures to factor risks, of introducing complexity from actively managed investment programs.

d. By combining these different analytical techniques, while maintaining a consistent set of underlying capital markets return assumptions, the Office of the CIO was able to evaluate portfolio risk in a multi-faceted manner and take advantage of the different perspectives and strengths of each technique without being subject to the limitations of any individual technique.

2. Summary of the recommendations for GEP asset allocation as compared with Current Asset Allocation Policy Weights:

a. Reduce Public Equity from 42.5 percent to 30.0 percent.

b. Increase Private Equity from 11.5 percent to 22.5 percent.

c. Increase Absolute Return (Strategic Opportunities) from 23 percent to 25 percent.

d. Consolidate Real Assets and Real Estate to be Real Assets and increase allocation to 12.5 percent from the combined 10.5 percent.

e. Consolidate Fixed Income and Liquidity to be called Liquidity with an allocation of ten percent reducing the Fixed Income current weight by 2.5 percent.

See complete recommended changes for GEP asset allocation in the table below:

	CURRENT	PROPOSED	Change
Total Public Equity	42.5	30.0	(12.5%)
US Equity	21.0	15.7	(5.3%)
Non-US Equity	14.0	11.0	(3.0%)
Emerging Market	7.5	3.3	(4.2%)
Private Equity	11.5	22.5	+11.0%
Absolute Return	23.0	25.0	+2.0%
Real Assets	3.0	12.5	+2.0%
Real Estate	7.5		
Liquidity	12.5	10.0	(2.5%)
Reference Portfolio	61% Equity	63% Equity	+3.0%
Illiquid	**34%**	**48%**	**+14.0%**
Return to Risk	**0.50**	**0.51**	**+0.01%**
Volatility	**11.4**	**11.8**	**+0.40%**
Real Return (>10Y)	**5.7**	**6.0**	**+0.30%**

Attachment: University of California General Endowment Pool Investment Policy Statement, Appendix 1, Section A