603 Investment Policy Statement (IPS) for UCRP

Committee on Investments
November 2004
OVERVIEW

◆ Best practice for institutional funds
◆ IPS consolidates all Regents’ investment policies in one coherent framework
  - Focus is on principal investment risks and management / accountability for those risks
◆ IPS addresses
  - Governance and key responsibilities
  - Investment policies, including development of risk budget and strategic asset allocation
  - Fiduciary oversight procedures
  - Performance objectives
  - Investment guidelines for each asset class and general guidelines for all investment managers
PRINCIPAL CHANGES

◆ Focus on management of risk
  ▪ Committee assesses risk tolerance and sets overall risk budget
  ▪ Treasurer and Consultant develop asset allocation, which Committee approves
  ▪ Committee approves budget and ranges for various risk measures; Committee approves benchmarks
  ▪ Treasurer implements asset allocation within those risk limits
    ◆ Treasurer given additional flexibility to optimize return, balanced by requirement to diversify portfolios

◆ Elimination of sub-optimal and duplicative investment restrictions

◆ See Appendix for detailed proposed changes

◆ IPS for GEP in development
BACKGROUND

◆ Rationale for consolidating investment policies
  ◆ Substantial changes in Regents' philosophy toward governance, investment strategy, and managing risk since 2000
    ◆ Closer oversight by Committee, IAC, and Office of the President
    ◆ Increased complexity in investment strategies
    ◆ Increased benchmark sensitivity
  ◆ Ameliorate agency issues by clearly articulating roles and responsibilities
  ◆ Permit flexibility and judgment in implementation, within pre-defined limits
ELEMENTS OF SOUND INVESTMENT POLICY*

- **Explicit responsibilities**
  - The responsibilities of each group should be explicitly designated and collectively understood.
  - In particular, the Board should focus on setting the goals and risk tolerance of the Retirement fund.

- **Comparative advantage harnessed**
  - To the extent possible, each party should be able to add its unique contribution to the overall investment process.

- **Unduly constraining policies avoided**
  - Crude risk controls, such as narrow position restrictions for managers, should be avoided.

- **Sufficient safeguards imposed**
  - Ethics standards, independent performance calculations, internal controls, relevant reporting to the Board.

IPS CONTENTS / ORGANIZATION

◆ Investment Policy Statement
  ■ Mission, Key responsibilities, Philosophy, Principal risks
  ■ Investment policies, risk budget, strategic asset allocation
  ■ Fiduciary oversight procedures
  ■ Performance objectives
  ■ Investment guidelines for all investment managers

◆ Appendices
  ■ 1: Asset allocation and ranges, Asset class benchmarks, Total fund benchmark, Rebalancing policy
  ■ 2: Risk management and budgets
  ■ 3: Funding Policy
  ■ 4: Derivatives Policy
  ■ 5: Proxy voting policy
  ■ 6: Manager Selection and Retention
  ■ 7: Asset class investment guidelines
WHAT HAS NOT CHANGED

- Committee approves asset allocation and ranges (strategic policy’’)
- Committee approves benchmarks for asset classes
- Committee approves investment guidelines for asset classes and total Fund
- Committee delegates implementation of policy to Treasurer
- Committee appoints various consultants to assist in oversight or provide expertise
- Treasurer reports to Committee quarterly on investment results and risks
- No change to overall Equity / Bond allocation of 65/35%
- No change to benchmarks (except for Private Equity)
- Essence of investment governance: to balance flexibility in use of professional judgment to implement policy by requirement to manage and control risk
  - Implicit in existing policy; now made explicit
MAJOR CHANGES FROM CURRENT POLICY

- Various investment risks identified and responsibilities/accountabilities clearly defined
- Committee sets risk budget and ranges for total and active risk
  - Treasurer implements asset allocation within risk budget
  - Treasurer has more flexibility to allocate total and active risk within and between asset classes [within risk budget]
  - Treasurer permitted to use risk management strategies to protect portfolio value
- Explicit prohibition on use of leverage (except within specific strategies)
- Committee to review actuarial status and various measures of surplus risk
- Additional total Fund performance objectives
- Remove general restrictions on short positions
MAJOR CHANGES FROM CURRENT POLICY 2

- Recognition of interim allocation for purpose of setting ranges around policy weights (due to illiquid nature of PE, RE)
- Combine public equity classes (US and Non US) for purpose of setting ranges around policy weights; increase combined range from +/-7% to +/-10%
- Same for public bond classes (Bonds and TIPS)
- Remove specific percentages of active versus passive management within asset classes; replaced by total Fund and asset class risk budgets
- Eliminate distinction between portfolios managed by Treasurer versus managed externally
- Modify total Fund benchmark by using actual Private Equity return as benchmark; neutralizes impact of PE on active return
- Rebalancing to within range, not necessarily back to policy weight
MAJOR CHANGES FROM CURRENT POLICY 3

- Establish metrics for total and active risk (and rules for calculation)
- Removal of various sub-optimal concentration restrictions in asset class guidelines; replaced by active risk budget for asset class
- Establish currency risk policy; explicit use of unhedged benchmark
- Added section on Funding policy (stating Regents’ current policy)
- Added section on Derivative policy; authorized and unauthorized derivative uses outlined; control process established
- Added section on Investment Manager Selection and Retention policy to incorporate best practices
- CFA Institute Code of Ethics adopted
Risks: Definition & Accountability

- **Capital market risk** is the risk that the investment returns associated with the Committee’s asset allocation policy are not sufficient to provide the required actuarial return.
  - Responsibility for the overall level of capital market risk lies with the Committee.

- **Investment style risk** is the performance differential between an asset class’s market benchmark and the aggregate of the weighted managers’ benchmarks within the asset category.
  - This risk is an implementation risk and is the responsibility of the Treasurer.

- **Manager value-added risk** is the performance differential between the aggregate of the managers’ actual (active) portfolios and the aggregate of the managers’ benchmarks, both at policy allocation weights.
  - This risk is an implementation risk and is the responsibility of the Treasurer.

- **Tactical/strategic risk** is the performance differential between policy allocations and actual allocations.
  - This risk is the responsibility of the Treasurer.
RISKS: DEFINITION & ACCOUNTABILITY 2

◆ **Total Active risk** refers to the volatility of the difference between the return of the Trust policy benchmark and the Trust actual return. It incorporates the aggregate of Investment style risk, Manager value-added risk, and Tactical/strategic risk
  ▪ This risk is the responsibility of the Treasurer

◆ **Total Investment risk** refers to the volatility of the return of the Trust assets and incorporates all elements of investment risk as enumerated above
  ▪ This risk is the joint responsibility of the Committee and the Treasurer

◆ **Surplus risk** refers to the volatility of change in dollar value of Trust assets versus change in dollar value of the Plan’s liabilities
  ▪ This risk is the joint responsibility of the Regents and the Committee

◆ **Peer risk** refers to the difference in Trust performance relative to peer institutions
  ▪ This risk is the responsibility of the Committee
SUMMARY OF REPORTING REQUIREMENTS

◆ The investments of the Retirement fund shall be reviewed no less than quarterly to monitor that policy guidelines are met:
  ▪ The Committee shall monitor investment returns on an absolute and benchmark relative basis, as well as monitor investment risk and returns adjusted for risk.

◆ The performance of the overall Trust will be measured relative to:
  ▪ The actuarial rate of interest
  ▪ Funded status
  ▪ Inflation
  ▪ Policy benchmarks

◆ The Treasurer shall report quarterly to the Committee:
  ▪ The achievement of overall performance objectives
  ▪ The type and amount of risk taken to achieve those objectives
  ▪ Attribution of returns to various investment decisions and risks
  ▪ Adherence to budgets set for total and active risk
  ▪ Compliance with policy guidelines, particularly asset allocation policy
  ▪ The costs of managing the Retirement fund’s assets
SUMMARY OF REPORTING REQUIREMENTS

- The Treasurer will report quarterly to the Committee:
  - Total Investment risk relative to risk budget and ranges
  - Total Active risk relative to risk budget and ranges
- The Treasurer will report quarterly / annually to the Committee:
  - Surplus risk measures
- The Treasurer will report quarterly to the Committee for each major asset class:
  - A performance attribution explaining differences in sector weights and returns, between the aggregate Program investments and the benchmark
  - A forecast risk report showing the total, systematic (“common factor”), and non-systematic (“residual”) risk of the aggregate portfolio, the benchmark, and the active Program relative to the benchmark
  - A summary of individual manager performance, on an absolute and relative basis
- The Treasurer will report annually to the Committee regarding proxy voting