The Regents of the University of California

COMMITTEE ON INVESTMENTS
INVESTMENT ADVISORY GROUP
February 27, 2014

The Committee on Investments met on the above date by teleconference at the following locations: Covel Commons, Los Angeles campus; 1111 Franklin Street, Lobby One, Oakland.

Members present: Representing the Committee on Investments: Regents Feingold, Makarechian, Schultz, Wachter, and Zettel; Advisory member Jacob; Staff Advisor Coyne
Representing the Investment Advisory Group: Members Crane, Martin, Rogers, Samuels, and Chief Financial Officer Taylor, Consultants Klosterman and Lehmann

In attendance: Regent Sherman, Associate Secretary Shaw, Chief Deputy General Counsel Petrulakis, Co-Acting Chief Investment Officers Stanton and Wedding, and Recording Secretary McCarthy

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

1. **PUBLIC COMMENT**

Committee Chair Wachter explained that the public comment period permitted members of the public an opportunity to address University-related matters. The following persons addressed the Committee concerning the items noted.

A. Ms. Kitty Jones, second-year student at UC Berkeley and member of Fossil Free Cal, said the quickly growing fossil free movement represented a broad coalition of students, faculty, and alumni, with representation from nine UC campuses. The movement’s goal is to have the University divest its investment holdings from fossil fuel companies. Ms. Jones expressed support for establishment of a task force on socially responsible investing.

B. Mr. Jake Soiffer, UC Berkeley student and member of Fossil Free Cal, commended the appointment of incoming Chief Investment Officer (CIO) Bachher, noting his prior support of green energy solutions and his involvement with biofuel, solar, and wind industries. Mr. Soiffer said Fossil Free Cal looked forward to working with Mr. Bachher and the Regents to implement sustainable investment policies, making UC a leader in the fight against climate change.

C. Mr. Ophir Bruck, fourth-year UC Berkeley student and member of Fossil Free UC, expressed support for establishment of a task force on socially responsible investing, which could be a vital step in aligning UC’s investments with its ideals, public mission, and President Napolitano's recently announced carbon-neutrality initiative.

D. Ms. Victoria Fernandez, third-year UC Berkeley student, advocated the prompt establishment a task force on socially responsible investing; the addition of consideration of divestment from fossil fuel industries and reallocation to sustainable energy investments to the agenda of the Committee on Investments; and holding a meeting with students representing the fossil free movement and incoming CIO Bachher prior to the next Committee meeting.

Committee Chair Wachter commented on a recent article regarding investment returns of the General Endowment Pool (GEP), noting that the article focused on ten-year returns. An examination of five- and one-year returns, which are far better, demonstrated movement in the right direction. One criticism was that investment policies for the GEP have been too conservative and that the GEP had not been managed differently enough from the UC Retirement Plan (UCRP). Committee Chair Wachter expressed his view that the GEP had not been managed in a modern way ten years ago, nowhere near the Swensen model, the investment management and asset allocation model developed by Mr. David Swensen in managing Yale University's endowment. In the past five or six years, investment policies for the GEP have moved much closer to that model and investment results have improved over time. An advantage of UC's more conservative approach was that during the financial crisis of 2008, UC's investment posture resulted in its losing less money than other endowments and avoiding liquidity issues that confronted more aggressively invested endowments.

Committee Chair Wachter agreed that the GEP and the UCRP are different and should be considered separately. They were managed similarly ten years prior, but in recent years the asset allocation of the GEP had been changing. UC's investment policies must be considered in the context of a public university with some real constraints in terms of structure, disclosure requirements, and resources. UC had two CIOs during the past ten years and the Committee looked forward to working with the incoming CIO. Structural changes in the way the UCRP and the GEP are managed would also be considered. Committee Chair Wachter complimented Co-Acting Chief Investment Officers Stanton and Wedding for their excellent work during this transition.

Investment Advisory Group member Martin commented that he had written an article that would be published in the *Orange County Register*.

2. APPROVAL OF MINUTES OF PREVIOUS MEETING

Upon motion duly made and seconded, the minutes of the meeting of November 5, 2013 were approved, Regents Feingold, Makarechian, Schultz, Wachter, and Zettel (5) voting "aye."[1]

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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.

3. **FOURTH QUARTER 2013 INVESTMENT PERFORMANCE SUMMARY**

[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.]

Co-Acting Chief Investment Officer (CIO) Wedding referred to a chart showing returns for the quarter ending December 31, 2013, the fiscal year to date, the calendar year to date, and three-, five-, and ten-year periods for the UC Retirement Plan (UCRP), the General Endowment Pool (GEP), the Short Term Investment Pool (STIP), the Total Return Investment Pool (TRIP), and the UC Entity. For the quarter, UCRP outperformed its benchmark by 35 basis points (bps); GEP outperformed by 85 bps; STIP outperformed by 39 bps; and TRIP outperformed by 21 bps. UCRP earned five percent absolute return for the quarter; for the fiscal year to date, or six months, UCRP returned almost 11 percent. For the calendar year to date, UCRP outperformed its benchmark by 132 bps and GEP outperformed its benchmark by 263 bps. The STIP portfolio continued its good performance of the past several years and TRIP tracked its index. Mr. Wedding pointed out that it was rare to have outperformance across every time period and for all UC funds.

Regent Makarechian asked whether the current market value figures included distributions that had been made. Mr. Wedding confirmed that the market value figures were as of year's end 2013 and did account for monthly distributions. Investment Advisory Group consultant Lehmann agreed that it was important to note the distributions from the funds. He recalled that the *San Francisco Chronicle* had incorrectly reported UC's investment returns during the financial crisis, because it neglected $4 billion in distributions. Investment Advisory Group consultant Klosterman said that the cash flows in and out of the funds did not affect their total returns. Mr. Wedding pointed out charts in Appendix 1 of the Investment Performance Summary showing the funds' market value and cash flows in and out. Chief Financial Officer Taylor commented that the $943 million cash outflow from the UCRP was the net amount including the cash inflows from employee and employer contributions, and outflows in pension payments. Regent Sherman noted that these figures reflected UCRP's assets; the pension's accrued liabilities were the other side of the equation. Mr. Wedding observed that in 2013 investing activities resulted in a $1 billion gain in the GEP and $500 million in TRIP.

Regent Makarechian asked why more funds were not invested in TRIP rather than STIP, given that the University's liquidity requirements were more than met by STIP and that TRIP earned higher returns. Mr. Taylor said that funds were being moved from STIP to TRIP over time. The University needed $4.5 billion to meet its liquidity requirements, including even a Black Swan scenario, meaning a major, unanticipated, and unpredictable event. Mr. Taylor said his office had been educating the campuses about investment opportunities in TRIP. Committee Chair Wachter asked whether funds from TRIP were ever moved into the GEP. Mr. Taylor responded that the TRIP contained long-term working capital that would not be needed for two to three years. His office had considered moving a portion of excess funds from STIP into the GEP, but when the Regents approved new investment guidelines for TRIP, that fund became a conservative version of the GEP. The campuses have been more comfortable using TRIP than the GEP. Investment Advisory Group member Samuels asked whether there were legal restrictions, since STIP and TRIP funds were operating cash and medical center profits, not gift funds. Mr. Taylor responded that, with the size of TRIP, the University could move funds and still have no problem complying with required ratios. Committee Chair Wachter added that the TRIP was currently invested to a large extent like the GEP. Mr. Taylor remarked that the goal was to increase unrestricted cash flow to the campuses.

Regent Makarechian asked whether the duration of the investments in TRIP was shorter than of those in the GEP, since the TRIP funds are used for liquid, cash flow needs. Mr. Lehmann observed that TRIP contained a great deal of excess liquidity. Mr. Taylor responded that the main difference was that the GEP contained illiquid alternative investments whereas TRIP had liquid alternatives. He added that the campuses were quite pleased with TRIP's performance. Investment Advisory Group member Martin commented that STIP had a great deal of excess capital that could earn better returns.

Regent Sherman asked whether there were any overlaps in managers between TRIP and the GEP. Mr. Taylor answered in the affirmative. Regent Sherman asked what would preclude the University from moving excess liquidity from STIP to the GEP or TRIP. Mr. Taylor responded that his office was exploring this question. Mr. Wedding commented that when TRIP was originated in August 2008 it was viewed as having an allocation halfway between a money market fund and a pension fund; at that time TRIP had a 65 percent allocation to fixed income. While this was not an endowment-style allocation, it performed extremely well over the period; the five-year return for TRIP was 11.2 percent and the five-year return for the GEP was 11.49 percent. Since then, the TRIP portfolio allocation had undergone a major change, with the fixed income allocation reduced greatly, and an increased allocation to private equity and alternatives. As a result, the asset allocation in TRIP was currently more similar to that of an endowment.

Regent Makarechian asked why the 9.85 percent one-year return for TRIP was so much lower than the 15.91 percent one-year return for the GEP. Mr. Lehmann attributed the difference to the fact that the TRIP did not contain any illiquid alternatives, such as real estate.

Mr. Samuels expressed his understanding that STIP funds were those that would be disbursed in the future, such as grant monies or salaries; these funds should not be invested in the same way as endowment funds. He said a common concern was that, should a major market downturn occur, there could be insufficient liquidity to cover necessary expenditures, such as happened at some major institutions during the 2008 financial crisis. Mr. Taylor responded that $4.5 billion would be more than sufficient to manage any Black Swan scenario. His office had analyzed cash flow requirements should many major negative events happen at the same time, and determined that $4.5 billion would be enough to handle these contingencies and still meet payroll. Mr. Lehmann added that this $4.5 billion necessary liquidity was held in STIP, which was invested very differently, almost like a money market fund.

Investment Advisory Group member Crane commented that funds in UCRP comprised about five-sevenths of the total funds being discussed, yet the materials provided did not show some important information, such as the ratio of retirees to active employees, or the relationship between the pension expense and the UC operating budget. He stated that the Society of Actuaries recently made several recommendations that he would forward to the Committee. Mr. Crane suggested that the Committee's agenda be arranged in such a way to address the very separate issues of the GEP and the UCRP. It would be important to understand the funding ratios, particularly for a public pension plan like the UCRP at a time when the Governor and the Legislature were taking the position that the State would not backfill UC's pension obligations. Investment performance should be discussed in the context of important measurements for public pension plans with shortening duration of liabilities. Committee Chair Wachter stated that investment performance was discussed first because of a recent article about the performance of UC's investments and because it is the Committee's responsibility to review investment performance each quarter. Mr. Taylor added that the subjects raised by Mr. Crane were often on the agenda of the Committee on Finance each November; he saw no reason that information could not be shared with the Committee on Investments as well. Mr. Crane said that from his perspective it was meaningless to discuss the UCRP without having the information he mentioned. Mr. Taylor expressed his view that the points raised by Mr. Crane were valid and said he would talk with Mr. Crane and prepare the requested information for the Committee. Mr. Lehmann agreed that the actuarial assumptions and funding ratios would be a good subject for a future Committee discussion. Committee Chair Wachter suggested that Mr. Crane and Mr. Taylor discuss how best to educate the Committee on this subject and its implications for the evaluation of investment performance and how the portfolio was invested.

Mr. Wedding reviewed quarterly public equity returns, which he characterized as extraordinary. The Russell 3000 Index gained ten percent for the quarter and 33.6 percent in 2013; the MS World ex-U.S. index gained 5.6 percent for the quarter. Core bond returns were flat; emerging market bonds were flat to negative. Mr. Wedding said the extraordinary returns in public equity are not replicable. He anticipated that returns for 2014 would be much more measured, although he thought public equity could still produce some excess returns.

Mr. Wedding discussed asset allocation. UCRP had a two percent tactical overweight in public equity and a two percent tactical underweight in fixed income. Within fixed income, the allocation to U.S. Treasury Bonds and other government securities had been consistently underweighted and the allocation to investment-grade corporate bonds and high-yield bonds overweighted. The underweight in Treasury Inflation-Protected Securities had helped returns. The mild underweight in alternative investments was not intentional. Managing Director Timothy Recker explained that the private equity asset class was currently underweight unintentionally and for a good reason. Since the beginning of 2013, the private equity portfolio had received more than 30 percent of every dollar invested back in cash distributions, a result of strong performance.

Committee Chair Wachter commented that the UCRP portfolio contained only a small amount of illiquid holdings in private equity, real estate, and absolute return. In response to Mr. Crane's earlier comments about the importance of having information about UCRP's funding ratios, Committee Chair Wachter asked about the extent of the Committee's ability to control these ratios, aside from managing the portfolio's liquidity. Mr. Crane responded that volatility, rather than liquidity, was relevant. Volatility had not been an issue for long-duration public pension plans in the past, but had increasingly become a concern. Contrary to commonly held views, some private equity holdings tend to be less volatile. Volatility would be important when a pension fund has liabilities, an increasing ratio of retirees to active employees, and the University has an increasing share of its operating budgets being taken up by pension expenses. This had become a bigger issue for UC since the Governor had indicated that UC would have to fund its pension liabilities on its own. Committee Chair Wachter commented that it might be helpful to include UC risk management personnel in this discussion at a future meeting.

Regent Makarechian asked whether the cash flow forecasts to which Mr. Taylor had referred earlier included pension payouts. Mr. Taylor answered in the affirmative. Regent Makarechian asked whether these forecasts included the possibility that UC might receive no further support for UCRP from the State. Mr. Taylor responded that he was hopeful that UC would receive support for its pension liabilities from the State, but his cash flow forecasts did not include any further State support.

Mr. Wedding reviewed the asset allocation in the GEP, which was similarly overweight in public equities and underweight in fixed income. TRIP had only a slight overweight in public equities and a slight underweight in fixed income. He noted the long-term target allocation of 20 percent to the cross asset class; the current actual allocation is ten percent. The long-term allocation would be considered in the context of a broader review of asset allocation.

Discussing performance attribution, Mr. Wedding stated that the opportunistic equity and absolute return asset classes contributed greatly to returns relative to benchmarks. The cross asset class had underperformed relative to its benchmark.

Regent Makarechian asked about the difference in asset allocation between the TRIP and the GEP. Mr. Wedding responded that the difference was in their alternative investments. Alternatives in TRIP include only absolute return and the cross asset class, while the GEP included those plus private equity, venture capital, and real estate.

Mr. Wedding stated that outperformance in the GEP was driven by the opportunistic equity and absolute return asset classes, as with the UCRP. He displayed a chart detailing performance attribution in the UCRP for the quarter. Manager selection in the opportunistic equity and absolute return asset classes contributed greatly to the UCRP's overall 34 bps of outperformance.

Regent Zettel asked whether the UCRP underweight in emerging market debt was an active decision. Mr. Wedding answered in the affirmative.

Committee Chair Wachter commented that it would be helpful to be able to analyze how the overall asset allocation helped or hurt investment results, in addition to the current reports of how the Office of the CIO's tactical over- or underweighting contributed to performance relative to the benchmark. Mr. Klosterman added that some asset classes were underweight in relationship to their benchmarks because investment opportunities had not been available.

Mr. Lehmann pointed out that the analysis referred to by Committee Chair Wachter could be obtained by comparing returns of a portfolio with the policy allocation with the returns of other large university endowments. Mr. Martin observed that the performance attribution was helpful in evaluating the effectiveness of the managers of each asset class.

Mr. Lehmann commented that some critics of UC's investment policy would have advised overweighting private equity during recent years, which would not have yielded good results in the past year when public equity performed so well.

Mr. Wedding displayed a chart showing performance attribution in the UCRP for the year ending December 31, 2013, during which time the portfolio outperformed its benchmark by 131 bps. Mr. Martin noted the exceptional 29 bps of outperformance attributed to manager selection in the absolute return class. Mr. Lehmann agreed that the absolute return results were extraordinary, particularly given UC's disclosure requirements.

4. INVESTMENT CONSULTANT REVIEW OF UNIVERSITY OF CALIFORNIA CAMPUS FOUNDATIONS THIRD QUARTER 2013 PERFORMANCE REPORT

[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.]

Mr. Terry Dennison of Mercer Investment Consulting (Mercer) displayed a graph showing investment performance of the ten campus foundations for various time periods, noting that their performances were similar. However, the UCLA Foundation's performance was somewhat lower, ranking in the 91st percentile of the Mercer Trust – Foundation and Endowment Universe. While the UCLA Foundation had been one of the top performers among the UC campus foundations in earlier quarters, it was hurt in the prior quarter by its relatively low allocation to public equities, which performed extremely well, poor security selection within its equity allocation, and relatively high allocations to hedge funds and real assets, which performed relatively poorly. For one-year and calendar year-to-date periods, all UC campus foundations had tightly grouped good performance, above the median of the Mercer Trust – Foundation and Endowment Universe.

Committee Chair Wachter asked whether the performance of the General Endowment Pool (GEP) was compared to the Mercer Trust – Foundation and Endowment Universe. Mr. Dennison said the performance of the GEP would be the same as the performance of either the UC Merced or the UC Santa Cruz Foundation, since they are both invested 100 percent in the GEP. Regent Makarechian asked whether the UC Merced and UC

Santa Cruz Foundations were saving management fees by investing completely in the GEP, and whether a policy to require the campus foundations to invest under one management in order to save fees had been considered. Committee Chair Wachter responded that it would be difficult to convince the campus foundations to invest completely in the GEP, since the campuses prefer to have their own foundations. Investment Advisory Group consultant Lehmann added that donors also like having their donations managed by the campus to which they donated. Regent Makarechian asked whether the amount of money the campuses could save by not investing their own funds had been determined. Committee Chair Wachter agreed that the campuses would obviously have additional costs in managing their own foundations. Regent Schultz commented that as the Office of the Chief Investment Officer (CIO) further differentiates its investment policies for the GEP from the UC Retirement Plan, it might be advisable to readdress encouraging the campuses to invest their foundation funds in the GEP. Committee Chair Wachter noted that most of the campus foundations have their own boards and relationships with their own donors, and prefer to manage their own foundations.

Regent Makarechian asked whether there is a fee for the campus foundations to invest their funds in the GEP. Mr. Lehmann said the fee is very small. Co-Acting Chief Investment Officer Stanton said that UC Santa Cruz and UC Merced benefit from the economies of scale by investing in the GEP because they gain access to managers at lower rates. Mr. Lehmann said that the UC San Diego Foundation, even with holdings of almost $500 million, could not gain access on its own to private equity or absolute return managers available to the Office of the CIO; the UC San Diego Foundation invests 70 percent of its funds in the GEP. Mr. Wedding said the Office of the CIO charges the campus foundations a management fee of seven or eight bps to invest in the GEP.

Mr. Lehmann asked Mr. Dennison if the comparator groups in the rankings of the foundations in the Mercer Trust – Foundation and Endowment Universe were segregated by endowment size. Mr. Dennison said the rankings were not segregated by size.

Investment Advisory Group consultant Klosterman inquired why the UC Santa Cruz and UC Merced Foundations had different percentile rankings for their five-year returns in comparison with the Mercer Trust – Foundation and Endowment Universe, if they were both totally invested in the GEP. Mr. Dennison explained that variations can occur because of cash flow in or out of the foundations on a given day. Mr. Dennison noted that 20 percent of the UC Davis Foundation was invested in the GEP, as was 30 percent of the UC Irvine Foundation and 68 percent of the UC San Diego Foundation.

Mr. Dennison displayed a graph of the foundations' absolute returns for periods ranging from the recent quarter up to ten years. Their absolute returns over all time periods were quite similar. Another graph showed the foundations' excess returns, which were not similar, because the foundations use different benchmarks. The UC Berkeley and UC Davis Foundation returns have been consistently poor relative to their benchmarks. Mr. Dennison explained that the benchmarks used by those two foundations were oriented toward a long-term, hypothetical portfolio, rather than reflecting the way the foundations were invested currently.

Mr. Dennison displayed a graph showing the foundations' levels of risk and return for three- and five-year periods, showing that most of the foundations earned good returns with low risk. UC Santa Barbara Foundation's low allocation to equities hurt its returns; UC Riverside's high allocation to equities produced more volatility. The comparison between the three- and five-year graphs showed that the risk/return profiles have improved, moving from having relatively high risk and modest returns, to having lower risk and higher returns.

Mr. Dennison showed a graph of seven foundations' actual asset allocations compared with their benchmarks. One of Mercer's functions is to assure the Regents that the foundations' asset allocations are within reasonable tolerances of their benchmarks, which is the case. A separate graph showed the UC Berkeley, UC Davis, and UCLA Foundations' actual allocations compared with their benchmarks. These foundations have allocations based not on asset classes, but rather on purpose-based categories, such as tracking inflation, tracking growth, or risk reduction. Mr. Dennison reported that Mercer was satisfied that these foundations' allocations also tracked their benchmarks within reasonable tolerances. He expressed his view that the purpose-based categories are a useful way to consider asset allocation. Traditional asset classes like bonds, stocks, alternatives, and hedge funds can be arbitrary. Categories that express a purpose, such as hedging risk against inflation, or growth, protecting against risk of loss, can be more helpful when making adjustments to allocations in the face of particular economic circumstances.

Mr. Lehmann asked whether the UC Riverside Foundation's asset allocation of more than 80 percent to public equities was in compliance with Regents' policy. Mr. Dennison replied that the Regents' rules were established when the campus foundations were granted the authority to manage their own portfolios. Originally, the rules required the campus foundations to be invested within a specified percentage of the allocation of the GEP, but the rules were subsequently amended so that the campus foundations' allocations had to be reasonable within the professional judgment of the general investment consultant of the Board of Regents. Mr. Dennison said that, while UC Riverside's allocation to public equity was fairly high, in Mercer's judgment it was reasonable.

Mr. Dennison explained another chart showing the foundations' over- or underweights to their policy allocations. He noted the UCSF Foundation's overweight in liquidity, commenting that it was hard to take issue with overweighting cash. Regent Makarechian asked whether this liquidity was related to the hospitals' daily cash requirements. Chief Financial Officer Taylor responded that the medical centers' cash requirements were handled through the STIP portfolio, completely separate from the UCSF Foundation. Mr. Lehmann said that the excess liquidity in the UCSF Foundation was likely investment proceeds that had not yet been invested. Regent Makarechian asked where funds are held that have been contributed by a donor for a specific hospital building project. Mr. Taylor explained that such funds are typically transferred to the UC Regents' portfolio, so that construction projects can be funded on an as-needed basis.

Mr. Dennison concluded by stating that Mercer had no matters of concerns to raise to the Committee.

The meeting adjourned at 2:55 p.m.

Attest:

Associate Secretary