

The Regents of the University of California

**COMMITTEE ON INVESTMENTS
INVESTMENT ADVISORY GROUP**

May 22, 2014

The Committee on Investments met on the above date by teleconference at the following locations: West Alumni Center, Los Angeles campus; Student Services Center, Room 405, San Diego campus; 1111 Franklin Street, Room 5318, Oakland.

Members present: Representing the Committee on Investments: Regents Feingold, Kieffer, Makarechian, Schultz, Sherman, Wachter, and Zettel; Faculty Advisors Barton and Coyne

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

In attendance: Interim Secretary and Chief of Staff Shaw, Chief Investment Officer Bachher, Executive Vice President and Interim Chief Financial Officer Brostrom, Deputy General Counsel Drown, and Recording Secretary McCarthy

The meeting convened at 1:40 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.

Ms. Kathy Barnhart, 1968 UC Berkeley graduate, expressed her view that divestment from investments in the fossil fuel industry was a moral issue crucial to the current generation of college students. She stated that divestment would be an effective tactic, recalling that UC had been a leader in the divestment movement from companies associated with South Africa. Reinvestment in renewable energy would be an important corollary, essential to solving the crisis. Holding investments in fossil fuel companies may be risky financially. She expressed appreciation for the establishment of a task force for socially responsible investing.

Committee Chair Wachter thanked Associate Chief Investment Officer Melvin Stanton and Senior Directing Manager Randolph Wedding for their work as Co-Acting Chief Investment Officers (CIO) and welcomed CIO Bachher, who was hired after an exhaustive search. Mr. Bachher worked most recently with the Alberta Investment Management Corporation.

Committee Chair Wachter stated that a task force on sustainable investing would be formed to explore issues around divesting from the fossil fuel industry. The task force would be chaired by Mr. Bachher and include Regents, members of the Investment Advisory Group (IAG), and some special advisors from the environmental community. The Committee takes this issue very seriously. Mr. Bachher has also been asked to examine whether the UC Retirement Plan (UCRP) and the General Endowment Pool (GEP) should be managed more separately.

IAG Member Samuels asked about the role of the IAG in discussions about divestment from the fossil fuel industry. Committee Chair Wachter responded that the initial task force would include a few IAG members. The task force would report to the Committee on Investments, which might then report to the Board.

2. **APPROVAL OF MINUTES OF PREVIOUS MEETING**

Upon motion duly made and seconded, the minutes of the meeting of February 27, 2014 were approved, Regents Feingold, Kieffer, Makarechian, Schultz, Sherman, Wachter, and Zettel (7) voting “aye.”¹

3. **FIRST QUARTER 2014 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.]

Chief Investment Officer (CIO) Bachher expressed appreciation to the Committee for his selection as CIO. Mr. Baccher invited Senior Directing Manager Randolph Wedding, who had been Co-Acting CIO during the relevant period, to discuss investment returns for the first quarter of 2014.

Mr. Wedding said he would discuss returns of the UC Entity, meaning all the assets managed by the Office of the CIO, and then discuss the UC Retirement Plan (UCRP) and the General Endowment Pool (GEP) separately, since their asset allocations differ substantially. The first quarter of 2014 proved difficult for the economy and for many markets. The preliminary advance estimate of the gross domestic product (GDP) for the first quarter was 0.1 percent. The tracking estimate of GDP, based on financial data that have come in since that time, suggested that the preliminary estimate would be revised downward. The consensus is that this weak performance was attributable to the effects of particularly harsh winter weather. If true, an increase in economic performance would be expected in the second quarter. The first quarter of 2014 was also the beginning of the term of the new Federal Reserve Board Chair, whose remarks in January led observers to believe that the Board of Governors of the Federal Reserve System would raise interest rates within six months of the end of its quantitative easing program, resulting in a sell-off in equities and an increase in interest rates. In mid-March, the Chair indicated that an

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

increase in short-term interest rates might be delayed longer than she had previously indicated, and the market tenor changed dramatically with rallies in emerging market equities and bonds. In the U.S. markets, small cap equities declined, and large cap stocks rose. If active managers' asset allocations were not well positioned for these changes, their returns were hurt.

In fixed income, interest rates fell from the beginning of the year to the end of the first quarter, confounding managers who had been anticipating an increase in interest rates. For example, 30-year Treasury bond interest rates declined sharply, falling 40 basis points (bps) during the first quarter.

For the UC Entity, Mr. Wedding reported that returns for all UC plans were in line with policy benchmarks. Total UC Entity assets were \$88.5 billion, exceeding the peak asset levels reached in September 2007 before the global credit crisis. All losses in UCRP from that period have been recouped. He pointed out that both UCRP and GEP had to continue to make payments to stakeholders during the financial crisis. In the first quarter of 2014, while absolute returns were good, several UC plans underperformed their benchmarks. For the fiscal year to date, the UCRP returned 12.68 percent.

Regent Makarechian asked whether the market value of the UC Entity included the contributions to the defined benefit plan, and whether the 12.68 percent fiscal year to date return on the UCRP included contributions and monies paid out to retirees. Mr. Wedding explained that the 12.68 percent was the return on assets invested; UCRP's market value includes any inflows from contributions and payouts. Committee Chair Wachter stated that the purpose of the chart displayed was to show investment returns. Mr. Wedding added that chart in Appendix 1 to the item showed cash flow in and out of the portfolios, as well as investment returns.

Mr. Wedding discussed asset allocation in UCRP and displayed a chart showing actual asset class weights relative to policy. The portfolio was mildly overweight in public equity, and underweight in the fixed income categories of core fixed income and Treasury Inflation-Protected Securities (TIPS), with minor overweights and underweights in various alternative asset classes. The portfolio has carried this active exposure for quite some time. The Office of the CIO was examining moving to a more neutral allocation. Committee Chair Wachter asked whether Mr. Wedding was referring to active versus passive management. Mr. Wedding responded that he was referring to asset allocation, and that allocations in various markets could be either actively or passively managed. The Office of the CIO constantly examines the relative benefits of active versus passive management, including consideration of total return and UCRP's liquidity requirements.

Mr. Wedding explained the factors contributing to UCRP's underperformance in equities relative to the benchmark. With its active managers, the portfolio had an overweight to small cap, an overweight to biotech in the opportunistic equity asset class, and an underweight to utilities. Those areas had all performed well in the time period leading up to March, but profit-taking and churning in the market in March and a mid-March sell-off in NASDAQ affected returns in those market sectors, while the overall equity market had

positive returns. In sum, certain positions held by the portfolio's active managers were disfavored during those few weeks in March.

Core and high-yield fixed income outperformed their benchmarks for the quarter. Emerging market debt underperformed its benchmark, although its absolute returns were good. Mr. Wedding explained that the riskiest emerging market debt assets experienced huge rallies in late March, for instance in Venezuela and Argentina, where UC's mild underweight affected its returns.

Committee Chair Wachter asked Mr. Wedding to explain why the current allocations in some UCRP asset classes, particularly in equities and alternatives, were close to the short-term policy weights, but were quite different from the long-term target policy weights. Mr. Wedding responded that the pace at which the long-term target weights are reached was left to the discretion of the CIO. Mr. Bachher added that his office's alternative asset class groups have been very active in seeking opportunities for investments, although in his view investments in alternatives were currently expensive. Under current conditions, it would be better to sell alternatives than to buy them at relatively high prices. Mr. Bachher stated that his office was in the process of reviewing long-term asset allocation targets. Investment Advisory Group Consultant Lehmann noted that the UCRP portfolio was underweight in real estate, opportunistic, and cross asset classes relative to their long-term targets. Investing in real estate is a slow process and the opportunistic and cross asset classes are relatively new for the Office of the CIO. Mr. Lehmann anticipated that the long-term targets for those assets classes may change. Committee Chair Wachter stated that it would be beneficial for Mr. Bachher to review the long-term target asset allocations, which should be adjusted if necessary.

Regent Sherman asked whether it was by design that the underweight in alternatives roughly corresponded to the overweight in equities. Mr. Wedding stated that shorter term allocations are made based on the relative attractiveness of the various asset classes. He agreed with Committee Chair Wachter that it was not desirable to have a long-standing gap between long- and short-term target allocations. Mr. Lehmann recalled that the long-term allocations were based on the concept of moving funds from equities to alternatives, so the overweight and underweight in these two classes were connected. Committee Chair Wachter expressed his view that it would be preferable to decide on a strategy and then execute it relatively quickly, rather than have longstanding discrepancies between long- and short-term target asset allocations. He stated that some opportunities had been missed when the decision to increase the allocation to a strategy was not acted upon. Mr. Bachher stated that from his perspective the investment in the opportunistic equity asset class had been at a fast pace, since that asset class had been in existence at the Office of the CIO for only a year. Committee Chair Wachter stated that the pace of investing in real estate and in hedge funds had been slow. He expressed his view that it would be beneficial to make investments more quickly once long-term target allocations were established.

Mr. Wedding pointed out the strong quarterly returns of eight percent in private equity and almost four percent in public real estate. He discussed performance attribution for the

quarter in UCRP, which underperformed its benchmark for the quarter. The portfolio was overweight in its allocation to opportunistic equity, which performed poorly in relation to its benchmark; opportunistic equity contributed eight basis points (bps) of underperformance, four bps from manager selection and four bps from its overweight allocation. Five-eighths of the overall underperformance was attributable to public equity, with U.S. equity, non-U.S. equity, and emerging market equity combining for 15 bps of underperformance.

Committee Chair Wachter expressed his view that this breakdown of performance attribution was of interest to investment professionals, but a broader report about which investments performed well or poorly would be of more interest to a general audience. Mr. Lehmann stated that it was important to distinguish results based on manager selection from those based on asset allocation. He expressed his view that it is not a good indication if the portfolio is making most of its returns from asset allocation, since most performance based on market timing is unintentional. Mr. Bachher welcomed any suggestions to improve the presentations about investment performance.

Mr. Bachher displayed a slide that had been requested at a prior meeting showing UCRP's historical funded status, assets and liabilities, ratio of active to retired members, and funding ratios. Regent Makarechian asked whether this information would be forwarded to the Committee on Finance. Mr. Wedding responded that at the end of each fiscal year the Regents' consulting actuary examines UCRP's returns and liabilities, and presents the results of its analysis to the Committee on Finance each November. Regent Makarechian stated that it might be beneficial to provide more frequent updates to the Committee on Finance. Executive Vice President and Interim Chief Finance Officer Brostrom stated that an item would be brought to the July meeting of the Committee on Finance regarding UCRP's funded status and some potential internal borrowing that could help stabilize its funding and improve its funded ratio. Regent Makarechian expressed concern about borrowing to fund UCRP; Mr. Brostrom expressed his agreement and said a comprehensive strategy would be presented at the July meeting. Mr. Wedding added that, given the fiscal-year-to-date investment returns, which were much greater than the actuarial assumed 7.5 percent rate of return, UCRP's funded ratio should improve.

Mr. Wedding discussed GEP's asset allocations, which differ from those of UCRP. GEP's 53.5 percent policy weight for alternatives was much higher than the weight for alternatives in UCRP; GEP's 13 percent policy weight for fixed income and 33.5 percent public equity weight were lower than those asset classes' weights in UCRP. GEP's active policy weights, meaning its over- and underweights in various asset classes, were similar to those in UCRP: GEP had a mild overweight in public equities and a 2.7 percent underweight in fixed income. Mr. Wedding stated that his comments about UCRP asset class performance would pertain to GEP as well. Specific sectors in public equity that had been performing well, performed poorly in March; the Office of the CIO still favored those holdings. Mr. Wedding displayed charts showing GEP performance attribution for the quarter and the fiscal year to date, detailing the source of its 48 bps of underperformance for the quarter. However, for the fiscal year to date, GEP

outperformed its benchmark by 126 bps, largely attributable to the absolute return and, to a lesser degree, opportunistic equity asset classes.

Mr. Wedding displayed a slide included in the presentation for the first time of the GEP payout. One chart showed the GEP actual market value and its smoothed market value. He explained that the smoothed value is used as the base for the payout rate of 4.75 percent of the 60-month moving average of market value. Even during the 2008 financial crisis, there was not a big dip in the smoothed market value. Using the smoothed value has the advantage of yielding a consistent flow of payout funds.

Mr. Lehmann asked why the performance of the absolute return asset class in GEP and UCRP were not the same. Mr. Wedding explained that there are different absolute return managers in UCRP and GEP.

Mr. Wedding displayed a chart showing GEP risk decomposition and pointed out that GEP's total active risk as of March 31, 2014 was 128 bps, which was less than half of GEP's 300 bps risk budget. He questioned whether the risk budget should be adjusted or the portfolio should be invested in a way that takes more active risk. Committee Chair Wachter clarified that active risk means risk relative to the benchmark. Mr. Wedding agreed.

Mr. Wedding stated that the asset allocation of the Total Return Investment Pool (TRIP) was markedly different from that of both UCRP and GEP. He recalled the discussion at the prior meeting of the cross asset class allocation in TRIP, noting that the Office of the CIO was in the process of re-evaluating the current 20 percent long-term target policy allocation. The actual weight of the cross asset class in TRIP was currently 9.38 percent and the long-term policy target could be reduced. Mr. Lehmann noted that there was a related overweight to fixed income, since that would be the asset class that would be reduced to fund an increase to the cross asset class. Mr. Wedding agreed. TRIP's asset class performance was affected by the same market conditions discussed in relation to UCRP and GEP. The TRIP portfolio underperformed its benchmark by 17 bps, which Mr. Wedding said was not a material amount. His office was pleased with the overall return for TRIP, as were TRIP investors, since it was substantially outperforming the Short Term Investment Pool (STIP).

Mr. Wedding discussed STIP, which he said had been a boon for its UC stakeholders. STIP is essentially a substitute for a money market fund, but takes somewhat more risk than a traditional money market fund would. STIP's returns have been quite good in relation to its benchmark, which is the return on a two-year Treasury bond. Many segments of the University depend on income from STIP, and the Office of the CIO had been able to sustain good returns, even in the current low interest rate climate.

Mr. Wedding called attention to charts showing portfolios that are investment options for 403(b) defined contribution plans in the UC Retirement Savings Plan.

Mr. Bachher summarized the key highlights of the quarter. He reminded the Committee that the UCRP and GEP are long-term portfolios, and the STIP has longer term holdings than the University's liquidity accounts. While the market was choppy for the quarter, for the fiscal year to date performance was above the benchmarks. These returns are to be appreciated, but looking at the market going forward, Mr. Bachher expressed his view that a variety of alternative asset classes were currently expensive. His office was reviewing asset allocations in U.S. equities relative to long-term target allocations in order to position the portfolios advantageously for the upcoming few quarters. Asset values in UCRP and GEP are at all-time highs.

Committee Chair Wachter remarked that TRIP's more engaged investment posture over the past five years had been very successful in earning higher returns.

4. **ADOPTION OF EXPENDITURE RATE FOR TOTAL RETURN INVESTMENT POOL**

The Chief Investment Officer recommended and the Regents' General Investment Consultant concurred that the expenditure rate (payout rate) for the Total Return Investment Pool (TRIP) for the fiscal year 2014-15 be 4.75 percent times the average of the month-end TRIP net asset value, calculated over the 60 months ending in June 2015, to be implemented in stages, in order to avoid unnecessary volatility in the dollar amount of payout.

[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.]

Associate Chief Investment Officer (CIO) Melvin Stanton provided some background for the item. In May 2008, the Committee on Finance approved the asset allocation and investment guidelines for the Total Return Investment Pool (TRIP) with a total-return mandate appropriate for longer term working capital from the campuses. TRIP is designed to supplement the Short Term Investment Pool (STIP), which has a current income mandate appropriate for shorter term working capital. TRIP had \$7.1 billion in assets as of March 31, 2014.

Mr. Stanton explained that each year the Committee approves an expenditure (payout) rate for TRIP. The CIO recommended that the current payout rate of 4.75 percent of a 60-month moving average of the month-end net asset value (NAV) of the fund be maintained. The period over which the NAV is averaged would be implemented in stages, with the fiscal year 2013-14 payout based on the 12-month NAV ending June 2014; the fiscal year 2014-15 payout based on the 24-month NAV ending June 2015; and so on until a 60-month NAV is reached. This payout formula would be more consistent with the longer term nature of TRIP liabilities and the desire for a growing stream of income.

Upon motion duly made and seconded, the Committee approved the Chief Investment Officer's recommendation, and voted to present it to the Board, Regents Feingold, Kieffer, Makarechian, Schultz, Sherman, Wachter, and Zettel (7) voting "aye."

5. **INVESTMENT CONSULTANT REVIEW OF UNIVERSITY OF CALIFORNIA
CAMPUS FOUNDATIONS FOURTH 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) discussed the investment performance of the UC campus foundations in the fourth quarter of 2013. He displayed a chart showing that the asset allocations for the ten UC campus foundations were very similar, with the exception of the UC Riverside Foundation, which had an 85 percent allocation to public equity. Mr. Dennison expressed his view that, although this allocation was highly diversified within public equities, with global equity including emerging market equity, the allocation was approaching the bounds of prudence. Mercer's view was that, should this allocation continue to increase or become less diversified, it would be raised as an issue with the Regents. From a market timing perspective, the allocation had worked well: in the current market it had been the ideal allocation, since every other asset class underperformed public equities. Mr. Dennison reminded the Committee that UC Merced's and UC Santa Cruz's foundations were invested entirely in the General Endowment Pool (GEP).

Mr. Dennison referred to a chart showing the campus foundations' total annualized returns. He explained that the chart covers only five years, but the following quarter's report would include data for seven years on a quarterly basis.

Investment Advisory Group Member Samuels asked whether the average annualized total returns included returns on both the portions of the campus foundations' funds invested in the GEP and on the foundations' own investments. Mr. Dennison answered in the affirmative. Another chart showed the proportion of funds from each campus foundation invested in the GEP. Investment Advisory Group Consultant Lehmann commented that the UC San Diego Foundation currently invested 70 percent of its funds in the GEP.

Mr. Dennison discussed a chart showing the returns of the campus foundations for various periods up to five years compared with the Mercer Trust – Foundation and Endowment Universe, which represents a wide range of endowments and foundations for which Mercer measures performance. The performance range for the ten UC campus foundations was grouped around the median and for recent periods somewhat above the median, more toward the middle of the second quartile. The UC Riverside Foundation's performance had risen substantially above the group; for the recent quarter it ranked in the second percentile, a result of having a large allocation to public equity when it performed well. Committee Chair Wachter asked for a clarification of the comparison universe. Mr. Wedding explained that it represented Mercer's universe of all endowments

and foundations, not differentiated by size, since the UC campus foundations varied greatly in size. Mr. Martin commented that, although its 85 percent allocation to public equities worked well for the UC Riverside Foundation in the fourth quarter of 2013, such a large allocation to public equities raised concerns. He asked if it would not be appropriate to have an advisory discussion with the UCR Foundation managers. In response to a question from Committee Chair Wachter, Mr. Dennison said the UCR Foundation holds \$125 million in assets. Regent Makarechian pointed out that the UCR Foundation's 85 percent allocation to public equities included a 42 percent allocation to global equities. Committee Chair Wachter suggested that Mr. Dennison meet with the manager of the UCR Foundation regarding the well-known risk of such a high public equity allocation, which he said was not close to a normal model allocation for endowments, and report back to the Committee.

Committee Chair Wachter also raised the question of whether the smaller campus foundations' assets might be better invested in the GEP. Regent Sherman asked why the campus foundations managed their own portfolios, given that the five-year returns of all of the campus foundations were lower than returns for the UC Entity, and the foundations that managed their own investments would also incur higher management expenses than the very low management fee the Office of the CIO would charge. Committee Chair Wachter pointed out that for one- and three-year periods, the foundations' returns had improved. While he agreed with Regent Sherman, Committee Chair Wachter noted that in many cases the foundations want to manage their holdings independently. The argument has been made that the Office of the CIO could earn better returns at lower cost. The Committee has a fiduciary role in relation to the campus foundations.

Regent Kieffer asked whether Mr. Bachher would meet with the campus foundations. Mr. Bachher responded that he had already met with some foundations and had recently met with the UC Riverside Foundation, although not with its investment manager. Regent Kieffer expressed his view that it would be important for Mr. Bachher to meet with the UCR Foundation manager with a message coordinated with Mr. Dennison's. Mr. Dennison commented that he would meet with the manager of the UCR Foundation under the sanction of the Committee, but cautioned that, as the general consultant to the Regents, he could not provide investment advice to the foundations. Committee Chair Wachter suggested that Mr. Dennison accompany Mr. Bachher who could provide advice. Mr. Bachher added that he would report on the meeting to the Committee.

Regent Sherman asked why the campus foundations performance reports lagged a quarter behind the performance reports of the UC Entity. Mr. Dennison explained that data from the ten campus foundations must be reviewed by the individual foundations, consolidated, and audited. When Mercer started this review process six years ago, the lag had been nine months; that has been improved to only three months.

In conclusion, Mr. Dennison displayed graphs showing the campus foundations' returns, both absolute returns and relative to their benchmarks. He observed that the absolute returns were similar, particularly for three- and five-year periods, despite differences in asset allocations and strategies. He noted that the legends in the graphs of excess return

after adjusting for beta show the proportion of each campus foundation invested in the GEP. Displaying another graph showing risk and return, Mr. Dennison pointed out that the UCR Foundation had more volatility and significantly more annualized risk than the other foundations. The other campus foundations were tightly clustered with similar risk, all with less risk than the median of the Mercer Trust – Foundation and Endowment Universe. A graph showing policy compliance, or asset allocation compared with benchmarks, showed no significant deviation from benchmarks. He explained that the UC Davis Foundation's allocations did not add up to 100 percent, because of a small amount of leverage in its portfolio.

The meeting adjourned at 3:05 p.m.

Attest:

Interim Secretary and Chief of Staff