The Regents of the University of California

COMMITTEE ON INVESTMENTS
INVESTMENT ADVISORY GROUP
September 12, 2014

The Committee on Investments met on the above date by teleconference at the following locations: James West Alumni Center, Los Angeles campus; Mosher Alumni House, Santa Barbara Campus, 1111 Franklin Street, Lobby One, Oakland.

Members present: Representing the Committee on Investments: Regents Kieffer, Lozano, Makarechian, Saifuddin, Sherman, Wachter, and Zettel; Advisory Members Gorman, Hare, and Oved; Staff advisor Coyne

Representing the Investment Advisory Group: Members Crane, Samuels, and Taylor, and Consultant Klosterman

In attendance: Faculty Representative Gilly, Secretary and Chief of Staff Shaw, General Counsel Robinson, Chief Investment Officer Bachher, Executive Vice President and Interim Chief Financial Officer Brostrom, Recording Secretary McCarthy

The meeting convened at 1:35 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. Mr. Alden Phinney, UC Santa Cruz undergraduate student, member of Fossil Free UC, and member of the Task Force on Sustainable Investing (Task Force), stated that UC's pledge to become climate neutral in 11 years was a costly and bold endeavor. Mr. Phinney stated that UC must also lead by investing in what helps and divesting from what harms. He acknowledged that investing in sustainable solutions would be important, but UC would not effect systemic change nor be seen as a true leader in sustainability without acknowledging problems in its investments. The Task Force's second recommendation entailed implementation of an environmental, social, and governance (ESG) framework that Mr. Phinney said purported to take into account carbon risk, but the world holds four times the carbon assets that could be burned if internationally agreed-upon targets were to be reached. Mr. Phinney expressed his view that the ESG policy must include divestment from the fossil fuel industry to address carbon risk. He recommended targeted divestment from the coal industry as a first step in aligning UC's investments with its obligations as a climate leader. Mr. Phinney also stated that student representatives must be involved in setting up the implementation of sustainable investing frameworks and the ESG policy. He urged the Regents to form a standing committee on investor responsibility.

B. Ms. Victoria Fernandez, fourth-year UC Berkeley student, read a letter from Donald Gould of Gould Asset Management, trustee and chair of the investment committee at Pitzer College, to the Committee on Investments. Mr. Gould urged UC to divest its endowment from holdings in the fossil fuel industry, noting Stanford's recent decision to divest from holdings in the coal industry. Fossil fuel divestment would be one element of a sustainable investment program and would set an example for others to follow. Divestment would be entirely consistent with UC's strong commitment to sustainability. Mr. Gould's letter stated that in April, Pitzer College announced a comprehensive climate action plan that included divestment from substantially all fossil fuel stock holdings in its endowment by December 31, 2014. Mr. Gould observed that the effect of the leadership of the University of California in the area of sustainability should not be underestimated. The costs of divestment must be weighed against the effects of climate change.

C. Mr. Kriss Worthington, Berkeley City Council member, stated that he officially represented the City of Berkeley, which endorsed the Fossil Free UC campaign. Eight of nine members of the Berkeley City Council favored the total divestment from the fossil fuel industry supported by Fossil Free UC. He reported that the City of Berkeley had adopted a fossil free investment policy. Mr. Worthington urged setting a timeline for implementation of the recommendations of the UC Task Force for Sustainable Investing.

D. Mr. Matthew Lewis, UC Berkeley undergraduate student, co-chair of the Chancellor's Advisory Committee on Sustainability at UC Berkeley, and member of the steering committee of the Cal Climate Action Partnership, read more of Mr. Gould's letter that Ms. Fernandez had begun. The letter stated that the argument that divestment from the fossil fuel industry would lead to other divestment requests was spurious, since very few issues have led to consideration of divestment in the past 50 years. The true "slippery slope" would be to continue on the current path of creating ever greater amounts of carbon dioxide. Mr. Gould urged UC to divest from the fossil fuel industry unequivocally. Mr. Lewis noted the University's and President Napolitano's leadership in sustainability and stated that divesting from fossil fuels was a necessary part of sustainability efforts. The argument that the University's divesting alone would have little effect on climate change could be used to argue against any of the many sustainability efforts UC has undertaken. Other universities would follow UC's lead by divesting.

E. Ms. Gabi Kirk, UC Santa Cruz alumna, said that she had been a leader of the UCSC sustainability office for four years and a member of the California Student Sustainability Coalition. Ms. Kirk urged the University to integrate divestment into the ESG framework, immediately divest from the coal industry, and incorporate students into the processes of determining the nature of socially responsible investment decisions.

F. Mr. Henry Morse, UC Santa Barbara third-year student and member of Fossil Free UC, said his work as an undergraduate researcher involved demonstrating ways in which climate change caused by anthropogenic greenhouse gas emissions would affect the earth in order to better prepare for the inevitable effects. Divestment would be an investment in the future. He stated that UCSB Fossil Free UC urged the Task Force on Sustainable Investing to include divestment in its recommendation because of overwhelming support for divestment from students and faculty from all UC campuses. He also called for the Committee to work directly with students and other members of the Fossil Free UC campaign.

2. APPROVAL OF MINUTES OF PREVIOUS MEETING

Secretary and Chief of Staff Shaw corrected a typographical error on page nine of the Minutes to say that the UC Riverside Foundation holds $125 million in assets. Upon motion duly made and seconded, the minutes of the meeting of May 22, 2014 were approved as amended, Regents Kieffer, Lozano, Makarechian, Saifuddin, Sherman, Wachter, and Zettel (7), voting "aye."[1]

3. FINDINGS OF THE TASK FORCE ON SUSTAINABLE INVESTING

[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.]

Committee Chair Wachter stated that he was a member of the Task Force on Sustainable Investing (Task Force), which consisted of Regents, UC faculty and students, and outside experts. The Task Force gave serious consideration to the issues before it, spending much time reviewing research, exchanging opinions, and engaging in thoughtful discussions.

Chief Investment Officer (CIO) Bachher thanked all those who helped to raise awareness of the challenge of climate change, one of the most important issues of this generation. To provide some context of the scale of the discussion, Mr. Bachher stated that almost 14 percent of the world's economy, or $11 trillion of global gross domestic product, was driven by energy and energy-related services. For the University, the Office of the CIO managed $91 billion in retirement, endowment, and working capital assets that directly benefit ten universities, five medical centers, and three National Laboratories, and all of their faculty, students, and staff. A substantial portion of those $91 billion, approximately $10 billion, was invested in energy and energy services companies.

Mr. Bachher thanked the UC students who raised the issue of divestment from fossil fuels for their passion, particularly Task Force members Alden Phinney and Victoria

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

Fernandez, who made compelling arguments. The Task Force also received hundreds of letters and other communications regarding fossil fuel divestment from people all across the University. Mr. Bachher stated that, for the Office of the CIO to fulfill the request to divest from the Carbon Underground 200, the 200 companies with the largest potential carbon emissions content of their reported reserves, the University would have to sell $3 billion of its investments.

In June, the 11-member Task Force, consisting of a cross-section of students, Regents, faculty, and experts in finance and sustainability from within and outside the University, began to consider issues related to UC's investments in fossil fuels. As a group, the Task Force recommended that the Office of the CIO adopt a series of actions toward investing in sustainability: first, to allocate $1 billion over the next five years for solution-oriented investments; second, to become a signatory to the United Nations' Principles for Responsible Investment (UNPRI); third, to establish and implement a framework for sustainable investment with the goal of completion by the end of the current fiscal year, or June 30, 2015; and fourth, to integrate environmental, social, and governance (ESG) factors as a core component of optimizing UC's portfolios and managing risks, evaluating all strategies for achieving ESG goals as soon as practical, including whether to use divestment. As of that week, UC became a signatory to the UNPRI, being the largest and first public university to do so. Adopting an ESG framework would ensure that the Office of the CIO takes into account not only carbon and climate risks, pricing them into its investments, but would also focus the Office of the CIO's investment staff's attention on many other important issues that may be of concern to its stakeholders and could affect its future investment results. An opportunity to effect change exists by investing in opportunities that enhance sustainability while earning a suitable return on investment. With President Napolitano's leadership, the University made a commitment to achieve climate neutrality by 2025. UC's Climate Leadership Council, led by Executive Vice President and Interim Chief Financial Officer Brostrom, was evaluating all possible ideas to achieve this goal. Many ideas to help achieve this goal, such as carbon pricing, were raised during the Task Force's discussions and would be considered by the Climate Leadership Council.

Mr. Bachher confirmed his dedication to integrate the Office of the CIO into the success of the operating and financial health of the University. By adopting the recommendations of the Task Force, the Office of the CIO's hard work of seeking ways to contribute toward solutions for climate change would begin.

Mr. Bachher added that, with the leadership of Faculty Representative Gilly, Chair of the Academic Senate and active member of the Task Force, its recommendations were examined by the Academic Senate's Committee on Faculty Welfare Task Force on Investments and Retirement and its Committee on Planning and Budget. The consensus of these committees was that they were willing to support the Task Force's recommendations.

Mr. Bachher explained that the Office of the CIO agreed as part of this process to alter dramatically the investment decision-making framework upon which it operates by hereafter looking at its investment portfolio through an ESG lens, finding ways to engage proactively with industry, and invest in solutions to the climate crisis. As an institution that sets the pace in innovation and research, UC would also lead by investing and commercializing these ideas for the world, starting in California. Mr. Bachher encouraged the Committee to adopt the recommendations of the Task Force. The University takes its position as an asset owner and a long-term investor very seriously.

Mr. Bachher concluded by stating that evaluating whether to sell $10 billion of $91 billion in assets, or even a more narrow list of $3 billion in holdings, must be taken most seriously. The Office of the CIO must be thoughtful and disciplined in its analysis as a prudent investor, and assess the consequences of its policies for the long term and their effect on the constituents to whom the Office of the CIO has a fiduciary obligation to maximize risk-adjusted returns. With climate change being one of the most pressing issues of this generation and as long-term investors, Mr. Bachher expressed his belief that investing through a lens of sustainability and helping to invest in solutions would be important contributions. Allocating money to invest in solutions would align with the University's overall leadership in sustainability and climate research, and was indicative of the seriousness with which the University considers issues of climate change.

Committee Chair Wachter expressed his view that, based on his experience on the Task Force, the Office of the CIO intended to implement the recommendations as quickly as possible, given the seriousness with which the members of the Task Force approached these issues. He expressed his view of the significance of the recommendations, including investing $1 billion in solutions-oriented investments, since finding solutions to the effects of climate change would be most important.

Investment Advisory Group member Samuels asked whether the funds for the $1 billion investment in sustainable solutions could come from proceeds of selling holdings in the coal industry. Committee Chair Wachter observed that the Task Force discussed divesting from coal and the current recommendations do not rule out any possibility. Mr. Bachher agreed.

Investment Advisory Group member Crane, who was also a member of the Task Force, stated that the deliberations of the Task Force were eye-opening. He noted that it had been almost a decade since then-Governor Schwarzenegger signed AB 32, the California Global Warming Solutions Act of 2006. He expressed his view that some options discussed by the Task Force, such as divesting from thermal coal, which he personally supported, would not solve any of the large climate problems. Mr. Crane expressed his view that the Task Force was very useful in its discussions of other possibilities, such as carbon pricing and accounting for carbon, which could solve big problems. He expressed hope that UC would pursue those possibilities closely in approaching its goal of achieving carbon neutrality.

Committee Chair Wachter said that the members of the Task Force agreed on the goal of effecting change, but differed on the best method. All options were still able to be considered.

Regent Zettel thanked those who served on the Task Force. She noted the very difficult financial issues that the Regents have faced in recent years and which have been handled very responsibly, such as unfunded liabilities in the UC Retirement Plan (UCRP). She urged caution with decisions that would affect investment of those retirement funds, citing the Regents' fiduciary obligation to UC retirees and current employees. Regent Zettel added that investment returns in UCRP can also affect student tuition. She expressed her hope that the Task Force's recommendations would be implemented in a thoughtful and disciplined manner, without inflexible deadlines that would constrain the Office of the CIO's investment decisions.

Committee Chair Wachter responded that Mr. Bachher was of the opinion that his office could implement an ESG framework by the end of the fiscal year; should that become difficult, Mr. Bachher could return to the Committee to seek an adjustment. Mr. Bachher stated that many other institutional investors have had ESG principles in place for almost a decade. For example, almost $45 billion of other institutions' assets are invested along the UNPRI, which would offer a very good starting point for the Office of the CIO as a guiding framework that can be adapted and modified according to UC's needs. Mr. Bachher stated he would advise the Committee at each meeting of his office's progress in implementing the Task Force's recommendations. Committee Chair Wachter said the intent was to earn good returns on the $1 billion allocation to solutions-oriented investments as well as to encourage sustainability.

Investment Advisory Group member Taylor expressed support for the positive approach of the Task Force's recommendations, noting that the $1 billion for solutions-oriented investments was a significant sum and would have a large effect. He cautioned that divestment comes with serious consequences, characterizing UC's decision 12 years prior to divest from tobacco companies as a financial disaster for the University. Mr. Taylor stated that tobacco divestment cost UC one-half billion dollars in investment losses, which would have to be made up by UC students, hospital patients, and the state's taxpayers. Mr. Taylor added that donors give to the University to further its educational and research goals, not to achieve carbon neutrality, and expect that their contributions will be invested wisely. Mr. Taylor also expressed concern about the effect divestment from fossil fuels could have on the University's ability to recruit and retain top investment personnel.

Regent Makarechian expressed support for the views expressed by Regent Zettel and Mr. Taylor, noting that approximately $200 million had to paid from UCRP to UC's retirees every month. By restricting the types of industries in which the Office of the CIO could invest, divestment would change the whole concept of the portfolios' asset allocation. Regent Makarechian asked what restrictions would be imposed on the University's investments by its becoming a signatory of the UNPRI and whether the University's asset allocation policies were being changed.

Investment Advisory Group consultant Klosterman asked about the source of funds for the $1 billion allocation to solutions-oriented investments. Mr. Bachher responded that the $1 billion would come from the General Endowment Pool (GEP) and the UCRP.

Mr. Klosterman pointed out that, since the funds were not coming from the assets in UC's defined benefit plans, the $1 billion would be a larger proportion of the GEP and UCRP than it would be of the UC Entity. He also asked whether the opinion of legal counsel had been sought to evaluate the Task Force's recommendations. Mr. Klosterman expressed his assumption that, should divestment be considered, legal counsel would be sought regarding the Employee Retirement Income Security Act and diversification requirements. General Counsel Robinson responded that members of his staff had reviewed the proposed recommendations and found them acceptable from a legal standpoint.

Regent Kieffer commended Mr. Bachher for this creative, significant proposal, which he said would have a larger effect than divestment in helping to find solutions to the demand for carbon fuels.

Regent Lozano agreed that the current proposals were prudent, yet innovative and bold, and expressed support for their positive focus on solutions, offering the University a chance to be a leader in this area. She expressed confidence in the Office of the CIO's ability to find appropriate investment opportunities in sustainable energy, while maintaining its focus on earning good investment returns. Regent Lozano noted the public comments at this meeting about maintaining the involvement of students as the investment framework is developed and encouraged such inclusivity.

Regent Sherman asked what returns were achieved from UC's coal investments during the equity boom of the past five years. Mr. Bachher stated that his office had $500 million invested in coal companies and $2.5 billion in oil and gas companies. Of the $500 million in coal companies, less than $10 million were direct holdings in coal companies; the balance was held in commingled funds through outside managers. The benefit of using an ESG framework in the future might be that investments in coal and oil sands would be challenged if one applied standards of greenhouse gas emissions per unit of energy produced or the price of carbon. The fact that the UC Entity holds only $500 million in coal companies demonstrates that external factors have been considered when evaluating possible returns on investment. Mr. Bachher stated that the effect on performance of removing fossil fuel companies from the UC Entity would have been a reduction of 30 basis points (bps), or 0.3 percent, in returns over the past ten years. Mr. Bachher pointed out that, while 30 bps might appear to be a small number, 30 bps of $91 billion would be a substantial sum.

Regent Saifuddin thanked the Task Force members for their work and expressed support for their recommendations. She stated that, as the student Regent, she was most concerned about maintaining student involvement in these efforts. She suggested including a recommendation that would require involvement of multiple undergraduate representatives in the continuing work on these proposals. She pointed out that this issue is being considered because of students' efforts. Regent Saifuddin also suggested promoting transparency and collaboration by having a standing body to examine possible investment opportunities aligned with the ESG framework.

Mr. Samuels asked for clarification of the amount of coal holdings in the UC Entity. Mr. Bachher responded that the UC Entity held $500 million in coal investments, including $10 million directly invested in coal companies and $490 million in commingled investments with outside managers. Committee Chair Wachter explained that to divest from commingled holdings would be much more difficult than from direct holdings. Mr. Samuels expressed his support for considering divesting from direct holdings in the coal industry.

Mr. Bachher responded that his staff had debated this option. Asset allocation policies are set by the Committee on Investments and are then delegated for execution to the Office of the CIO. He expressed appreciation for Regent Saifuddin and Regent-designate Oved's ability to express students' viewpoints to the Committee. This challenge must be addressed using a holistic framework that would provide a context for considering all options in the future, including the $10 million invested in coal. Regent Kieffer expressed his view that divesting UC's $10 million investment in coal would have no effect on the future use of coal, and would be inconsequential compared with the effect of investing $1 billion in aggressive support of sustainable solutions. Committee Chair Wachter stated that these options were discussed by the Task Force and its recommendations would not preclude any future actions. Regent Lozano added that the item also mentions that UC's shareholder and proxy voting positions are available as tools to achieve further sustainability.

4. **FISCAL YEAR 2013-14 INVESTMENT PERFORMANCE UPDATE**

[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 stated that he had been in his position only a few months and the investment returns he would report for the fiscal year ending June 30, 2014 were the results of his team's hard work. The actions of the Federal Reserve Board were the key driver of returns for the year. The ten-year U.S. Treasury Bond rate was 2.5 percent at the beginning of the fiscal year, climbed to 3.5 percent in the middle of the year, and ended the year back at 2.5 percent. The markets feared tapering of the Federal Reserve Board of Governors' program of quantitative easing, but then became comfortable with the pace of tapering. The Federal Reserve Board's comments indicating that increases in interest rates were not imminent calmed markets. Economic conditions in the United States improved; Europe's economic conditions were calmer with support from the European Central Bank; emerging markets shrugged off fears of tapering; and Japan added millions of dollars to its economy through quantitative easing. In sum, in the course of the year, markets exhibited nervousness, then settled down, creating a "risk-on" market, in which investors were likely to invest in higher risk assets. Low yields in fixed income investments led investors to favor equities, high-yield bonds, and investment-grade fixed income securities. This climate translated into excellent investment results for many institutions around the world.

The UC Entity had a 14.9 percent net return for the fiscal year, its assets increasing from $78.4 billion to $90.6 billion, with market gains of nearly $12 billion. In addition to gains from the very strong market, the Office of the CIO added one-half billion dollars in excess returns through active management. To position its portfolios for upcoming market conditions, the Office of the CIO would review its long-term asset allocations, since the anticipated return and risk are different than they were when the asset allocations were set a few years prior. Since assuming his position, Mr. Bachher has examined ways to optimize the UC Retirement Plan (UCRP) and the General Endowment Pool (GEP) portfolios according to their differing plan objectives, risk profiles, and payout requirements. Mr. Bachher observed that it would be unlikely for the markets to continue to rise from current levels and he anticipated a lower-return environment, in which managing costs would become very important. While asset allocation is a big driver of returns, active management would play an increasing role in generating returns. The size and scale of the $91 billion UC Entity can be advantageous in institutional asset management, particularly when combined with patience as a long-term investor. The unique knowledge in so many cutting-edge fields at the University can be leveraged to find investment opportunities to help position UC's portfolios for the future.

Mr. Bachher displayed a graph showing investment returns for various time periods, from 14.9 percent returns for one year, through 6.4 percent for ten years. He commented on the value added over the benchmark through the active management of the Office of the CIO consistently during the decade, particularly in the past five years. Returns consistently one percent over the benchmark are very difficult to achieve.

Pension assets constituted approximately 75 percent of the $91 billion UC Entity. The UCRP had grown to $52.1 billion. Working capital used to fund the day-to-day needs of the University was $14.7 billion, or 16 percent of the UC Entity. The GEP was nine percent of the UC Entity, or $8.3 billion. Taken as a whole, approximately half of the UC Entity, or $43.3 billion, was invested in equities, 32 percent, or $29.6 billion, was invested in bonds, and 20 percent, or $17.7, billion, was invested in alternative assets such as private equity, real estate, absolute return hedge funds, and other types of private instruments. The UC Entity was invested 70 percent in holdings in North America, with the balance of its assets invested in other parts of the world. Holdings in emerging markets grew from one percent of the UC Entity five years prior, to five percent currently.

Mr. Bachher displayed a graph showing the decline in the federal funds interest rate over the past 30 years, during a time of improving global economic conditions. A relatively accommodative monetary policy to promote the economy coupled with a rising stock market resulted in the recovery over the past year five years of losses from the global financial crisis of 2008, with stock markets having risen close to 200 percent. However, Mr. Bachher noted the backdrop of increasing geopolitical tensions around the world. He expressed his view that it would be difficult to imagine this high-return environment continuing and UC's portfolios should be positioned for a lower-return environment.

The GEP had an 18.7 percent net return for the past fiscal year, in the top fifth percentile of colleges and universities in UC's peer group. Mr. Bachher commented that his investment performance reports would include gross returns, part of his emphasis on managing costs. The GEP's gross return for the fiscal year was 20.3 percent; 160 basis points (bps) was paid in fees to external managers. Committee Chair Wachter asked whether these costs included internal management fees paid to the Office of the CIO. Mr. Bachher responded that internal management costs were approximately $30 million; the cost of external management was close to $600 million. Investment Advisory Group consultant Klosterman asked whether these costs included custody fees; Mr. Bachher answered in the affirmative, stating that the amount included all costs paid by his office to external managers. The GEP had been invested for 80 years, beginning with $100 million and 3,500 students at UC; the GEP had grown to its current $8 billion, with 230,000 students to support. Active management returns above the GEP's benchmark during the past five years had been close to 200 bps. Ten-year returns were close to seven percent annually.

The change in asset allocation adopted by the Office of the CIO over the past five years, including more alternative investments and private assets, had begun to yield higher returns. In the past fiscal year, the GEP's equity allocation had been two percent overweight relative to policy and its fixed income allocation had been 2.7 percent underweight; these weightings were beneficial, since equity markets rose more than 20 percent. The GEP portfolio was slightly overweight in alternatives and private assets benefited from a rising stock market. In addition, the J-curve effect, reflecting the high initial costs of investing in alternative assets, had begun to result in more distributions to the portfolio from its investments in private assets. Mr. Bachher stated that he intended to build up all the portfolios' cash positions so that liquidity would be available to take advantage of future opportunities.

Mr. Bachher discussed UCRP's fiscal year returns of 17.4 percent net and 18.2 percent gross, reflecting 80 bps in fees. During the fiscal year, UCRP grew from $45.1 billion to $52.1 billion in assets, and had cash outflows of $700 million to fulfill its obligations to UC retirees. Regent Makarechian asked whether the fees for UCRP at 80 bps were half of those for the GEP at 160 bps. Mr. Bachher said that was correct and reaffirmed his commitment to examine costs, particularly in the upcoming lower-return environment. In the longer term, the UCRP had returned 6.9 percent annually over ten years, which includes the period of the global financial crisis. UCRP's 20-year returns were close to 9.5 percent, important to consider with the actuarial rate of return at 7.5 percent.

Regent Sherman asked whether there was a correlation between the difference in costs for the GEP compared with the UCRP, and the value-added returns, or alpha, in those portfolios. The GEP had higher costs of 160 bps, but earned a far better return relative to its benchmark than the UCRP, which had half the costs but a smaller return above its benchmark. Mr. Bachher stated that this correlation definitely existed, because costs include incentive fees for performance as well as management fees, so higher performing managers were paid higher fees. Regent Sherman emphasized the importance of understanding this correlation.

Mr. Bachher stated that his comments about asset allocation in the GEP would also apply to the allocation in the UCRP, which was overweight in equities and underweight in fixed income. The UCRP portfolio was underweight in alternatives and the Office of the CIO was increasing the cash position in UCRP. Because of the difference in their risk profile, the GEP can have a larger investment in alternatives than can the UCRP.

Mr. Bachher discussed the University's $15 billion in working capital, divided roughly in half between the Total Return Investment Pool (TRIP) and the Short Term Investment Pool (STIP), with TRIP holding investments with a slightly longer duration of up to three to five years. TRIP had 14.6 percent net and 14.7 percent gross returns for the fiscal year, beginning the fiscal year with $4.6 billion in assets and ending with $7.6 billion, which included a cash inflow of $2.1 billion. Investment gains in the market yielded $0.9 billion. The TRIP portfolio had been created five years prior with the expectation that it would earn returns two to three percent higher than STIP's. Mr. Bachher said he planned to review the asset allocation of the TRIP portfolio over the coming year, since these returns indicate a risk profile that had benefited from a strong equity market. TRIP's returns were helped by its slight overweight to equities. TRIP's alternative asset allocation consisted of hedge funds and the cross asset class. Mr. Bachher stated that his office would review TRIP's allocation to the cross asset class, as well as examine the individual holdings in the cross asset class to position it for the future.

The STIP portfolio, the operating account for the University, returned 1.58 percent for the fiscal year, beginning the year with $7.9 billion in assets, paying $1 billion in cash outflows, and ending with $7.1 billion. The secular decline in interest rates over a 30-year period affected returns in STIP.

Regent Sherman asked why the University needed to have this amount of money in STIP, when a portion of those funds could be moved to TRIP to earn higher returns. Mr. Bachher agreed that this was an important question, which he and the Committee should address. He emphasized that the TRIP and STIP portfolios should be considered together in the context of working capital, and the allocation of funds between the two must be viewed not only in terms of possible returns, but also in terms of the appropriate level of risk for the University's working capital.

Executive Vice President and Interim Chief Financial Officer Brostrom stated that ways to move funds into higher yielding, more effective positions were being actively sought, such as the $700 million loan that had been made from STIP to UCRP since the fiscal year's end.

Mr. Bachher concluded his presentation by reiterating his view that the robust returns of the past fiscal year must be considered in light of the different objectives of the various portfolios managed by his office and that the portfolios' long-term asset allocations should be reviewed in that context. It would be difficult to replicate those returns in the future and the portfolios should be positioned for a lower-return environment. Managing costs by increasing efficiency and active management, particularly using managers with high-conviction portfolios, those based on the managers' best ideas and with the potential to generate excess returns over benchmarks, would play an increasing role. The Office of the CIO had benefited from its scale as a $90 billion organization. The advantages of being a long-term, patient investor became clear during the financial crisis and enabled the University to more than recoup its losses from that period. These same qualities of patience, size, and scale would enable the Office of the CIO to take advantage of opportunities to position its portfolios advantageously for the coming fiscal year.

Regent Makarechian stated that the amount of liquidity that should be held in STIP to meet the University's cash flow needs should be determined as soon as possible. He recalled that Advisory Group member Taylor had indicated at a prior meeting that $2.5 billion would be sufficient STIP funds to meet UC's cash flow needs. If the additional $5 billion dollars held in STIP had been transferred to TRIP, it could have earned 14 percent the prior year, or $700 million.

Committee Chair Wachter reminded the Committee that it is the Regents' responsibility to set asset allocation. The responsibility of the CIO and his staff is to implement that asset allocation and to try to earn excess returns above benchmarks when possible. In reality, the CIO and his staff make recommendations regarding asset allocation and setting the asset allocation becomes a joint venture with the Committee. Asset allocation is the main driver of returns and is extremely important. Committee Chair Wachter also commented that the excess returns above benchmark achieved by the Office of the CIO were excellent.

Committee Chair Wachter commented that the difference in costs, to which Regent Sherman referred earlier, between the GEP and UCRP portfolios was partially because the GEP portfolio included more alternative investments, which tend to have higher fees along with the potential for higher returns. He agreed that the amount of operating funds the University would require in STIP should be studied and reported to the Committee. In recent years, more funds had been moved from STIP to TRIP, and TRIP's asset allocation had been changed to more closely resemble that of the GEP. An appropriate balance between risk and return must be maintained, and the amounts of short-, medium-, and long-term capital needed by the University must be determined, and the asset allocations of STIP and TRIP adjusted accordingly. He asked Mr. Bachher and his team to study these questions and return to the Committee with recommendations. Regent Makarechian added that determining the amount of working capital required for the University's cash flow requirements should be straightforward. Committee Chair Wachter added that another question to be determined was how similar the asset allocation of TRIP should be to that of the GEP.

Mr. Brostrom expressed agreement with Regent Makarechian and noted that the University had been moving funds from STIP to TRIP. Mr. Brostrom recalled that he and Mr. Taylor, when Mr. Taylor was serving as Chief Financial Officer, had undertaken several liquidity studies. Each campus was limited to investing no more than 60 percent of its overall working capital in TRIP. Some campuses had been underinvested in TRIP, leading to higher holdings in STIP than would be optimal. Mr. Brostrom indicated that his office and the Office of the CIO would continue to examine the possibility of moving more funds from STIP to TRIP. Mr. Brostrom also expressed support for reducing TRIP's risk and return profile to an intermediate-term investment model as was originally intended in 2008.

Investment Advisory Group consultant Klosterman asked Mr. Bachher in what areas he intended to increase active management, noting that an effective way to manage costs was through the use of index funds. He also asked for more details of Mr. Bachher's recommendations for positioning the portfolios for the lower return environment he predicted. Mr. Bachher asked Deputy Director of Public Equity Paul Teng to discuss a strategy regarding active management. Mr. Teng stated that currently 40 percent of the UC Entity's public equities were invested in index funds, both domestic and international. An opportunity existed to decrease the allocation to passive index funds and increase the allocation to actively managed public equity portfolios in order to generate higher excess returns. Within the actively managed public equity portfolio, Mr. Teng would seek to optimize its active managers and dedicate more assets to high-conviction managers. Dedicating more assets to fewer managers could result in lower fees. Also his office would have more confidence in the potential for excess returns with these higher conviction managers. Mr. Bachher added that the holdings in the public equity portfolio must be examined as a whole to determine whether overlaps in holdings could result in overexposure to certain types of companies. When Mr. Bachher began as CIO, about 65 outside managers were used in the public equity portfolio. His office had been reviewing these managers to determine overlaps or inefficiencies, and planned to reduce the number of outside public equity managers to 40 by the end of the year in order to optimize the portfolio, allocate meaningful dollar amounts to the higher conviction managers, and negotiate more favorable fee schedules.

Regent Sherman asked what process the Office of the CIO would use to pick managers who would generate higher excess returns, when repeated studies have shown that managers who outperform benchmarks one year generally do not outperform the next year. Brian Gibson of the Office of the CIO agreed that selecting managers who could generate excess returns is very difficult. He commented that the excess returns earned in the UC Entity's portfolios demonstrated the strength of the Office of the CIO staff in selecting managers, an ability that he characterized as quite rare. It was also important to know when to drop managers who were not performing well. Regent Sherman expressed support for Mr. Bachher's intention to reduce the number of outside managers, because the University would gain leverage if the amounts allocated to the remaining managers were larger. Regent Sherman asked whether the Office of the CIO had complete transparency from its outside managers so it could know the concentration of its holdings in various industries. Mr. Bachher responded that his office has good, but not complete transparency.

Investment Advisory Group member Crane complimented Mr. Bachher on his performance report and expressed support for the suggestion that the University examine its working capital needs to optimize its investments. Mr. Crane asked whether Mr. Bachher anticipated a meaningful change in the asset allocation of the UCRP and, if so, by when. Mr. Bachher responded that he would review the asset allocation for all the portfolios, with a focus of positioning them for the lower-return environment he anticipated. The examination of the UCRP would include the 7.5 percent actuarial rate of return as a liability. These reviews needed to be accomplished quickly and results would be brought back to the Committee. Mr. Crane stated that the Office of the CIO's review should include a thorough consideration of the duration of UCRP's liabilities and how the duration would change over time.

Regent Makarechian asked whether there was a limit on the amount of funds that can be invested with a single manager. Mr. Bachher stated that his office was reviewing all of the portfolios; that review would lead to a review of the investment guidelines, after which he would return to the Committee with recommendations for changes to the guidelines.

Committee Chair Wachter recalled his request from a prior meeting that Mr. Crane make a presentation to the Committee about the importance of considering the duration of UCRP's liabilities.

5. **INVESTMENT CONSULTANT REVIEW OF UNIVERSITY OF CALIFORNIA CAMPUS FOUNDATIONS**

Mr. Terry Dennison of Mercer Investment Consulting (Mercer) discussed the investment performance of the UC campus foundations. He displayed a chart summarizing the average annualized returns for the ten campus foundations, noting that UC Merced and UC Santa Cruz invested all of their foundations' funds in the General Endowment Pool (GEP). Annual returns for the UC Riverside Foundation for the quarter ending March 31, 2014 were good because of its high public equities allocation, which had been discussed in the prior Committee meeting. Returns for the UC Santa Barbara Foundation continued to lag the other campus foundations' returns, which were closely bunched.

Chief Investment Officer Bachher reported that he and Mr. Dennison had met with the UC Riverside Foundation investment management regarding the asset allocation of its $130 million endowment. Mr. Bachher noted that, while one would expect an endowment to be at least partially invested in alternatives, the cost of alternatives would be very high for an endowment of that size. In place of alternatives, the UC Riverside Foundation was invested in global public equities, which Mr. Bachher characterized as a good proxy for alternatives, giving the UCR Foundation a good deal of liquidity. Given equity returns of the past five years, this allocation had been successful. While members of the Committee had expressed concern about the risk of having such a large allocation to public equities, Mr. Bachher expressed his view the UCR Foundation's asset allocation would not necessarily entail higher risk and was a lower cost implementation of a strategy seeking returns. Mr. Dennison recalled that he had expressed concern at the prior meeting that the UCR Foundation's unusually high allocation to equities could produce significant volatility. His discussion with the UCR Foundation's investment management showed that they had given this allocation a great deal of consideration and were aware of the potential for volatility. The investment structure of the UCR Foundation was positioned around having that volatility; the portfolio's structure would enable it to survive such volatility in the short term. Mr. Dennison stated that he was comfortable with the UCR Foundation's work and agreed with Mr. Bachher that this allocation was likely a cost-effective way for the UCR Foundation to manage a portfolio of its size.

Committee Chair Wachter asked whether Mr. Bachher and Mr. Dennison had discussed with the UCR Foundation's investment management the option of the UCR Foundation's investing in the GEP, which would offer an endowment of UCR's size a highly diversified, low-cost option yielding very good returns. Mr. Dennison said he could not presume to respond for the UCR Foundation staff, but he thought they were more comfortable managing their endowment by their own methodology. Committee Chair Wachter expressed concern that such a high allocation to global equities generally goes against basic principles of investing because global equities sometimes go through very bad periods. Investment Advisory Group member Crane stated that the UCR Foundation was structured to be able to handle expected volatility and was a low-cost alternative to investing for lower returns in order to gain protection from volatility.

Mr. Bachher added that he had made clear to the campus foundations that his office would share its expertise, investment relationships, and managers to which it had access in a spirit of teamwork, rather than simply to gain more assets.

Investment Advisory Group member Samuels asked how much larger returns the UC Santa Barbara Foundation would have earned if it had been invested in the GEP. Mr. Bachher responded that that amount could be calculated. Regent Sherman commented that, for longer periods of time, none of the campus foundations' returns equaled those of the GEP, and asked why they would not invest in the GEP. Committee Chair Wachter stated that some campus foundations felt that the donors who give to their campus want the funds managed by that campus. He encouraged Mr. Bachher to discuss the option of investing in the GEP with the campus foundations. Investment Advisory Group member Taylor stated that a comparison of returns for a ten-year period might be different, since the Regents had what he characterized as an excessively conservative asset allocation ten years prior, and many campus foundations employed more modern allocations. Since the asset allocations of the Office of the CIO have become less conservative, it could be helpful for the Office of the CIO to present options again to the campus foundations.

Regent Sherman asked whether the campus foundations would follow the recommendations of the Task Force on Sustainable Investing. Mr. Bachher said his office had indicated only that his office would follow these recommendations; the campus foundations were considering the implications of the United Nations' Principles for Responsible Investment.

Regent Kieffer observed that the campuses had new obligations to raise funds. Campuses gain a sense of ownership and motivation from their ability to invest their own funds, and this should be respected when presenting the option of investing campus foundation funds in the GEP. Committee Chair Wachter agreed that the best approach would be to offer help if desired. Mr. Bachher added that his office was looking for ways to partner with the campus foundations on investment opportunities. The size of the UC Entity offers the Office of the CIO some opportunities that could be shared with the campus foundations; the foundations also have opportunities that could be shared with the Office of the CIO.

The meeting adjourned at 3:45 p.m.

Attest:

Secretary and Chief of Staff