The Regents of the University of California

INVESTMENTS COMMITTEE
January 21, 2020

The Investments Committee met on the above date at UCSF–Mission Bay Conference Center, San Francisco.

Members present: Regents Anguiano, Leib, Makarechian, Park, Sherman, Um, and Zettel; Advisory member Bhavnani; Chancellors Hawgood, Khosla, and Wilcox; Advisor Zager; and Staff Advisor Klimow

In attendance: Secretary and Chief of Staff Shaw, Senior Counsel Katz, Chief Investment Officer Bachher, and Recording Secretary Li

The meeting convened at 2:05 p.m. with Committee Chair Sherman presiding.

1. **PUBLIC COMMENT**

Committee Chair Sherman explained that the public comment period permitted members of the public an opportunity to address University-related matters.

There were no speakers wishing to address the Committee.

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

Upon motion duly made and seconded, the minutes of the meeting of September 17, 2019 were approved.

3. **UPDATE ON ASSET CLASSES AND INVESTMENT PRODUCTS**

[Background material was provided to Regents 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 congratulated Regent Makarechian on his reappointment to the Board of Regents. He stated that, since 2014, UC investment assets have grown 45 percent to $132.6 billion as of December 31, 2019. The endowment has doubled, retirement assets surpassed $100 billion, and Working Capital remained steady. From June through December 2019 alone, UC investments grew $6.5 billion. In 2019, the pension grew 18 percent, the endowment grew 18.9 percent, the Total Return Investment Pool (TRIP) grew 14 percent, and the Short Term Investment Pool (STIP) grew 2.3 percent. The markets have grown despite uncertainty in international geopolitics. With the wide range of economic forecasts, liquidity and active management would be important, and governments might use fiscal stimulus packages to help global growth. Climate change could significantly affect asset prices, and European green spending could improve negative interest rates. The U.S. dollar could weaken, and global real estate could be an attractive diversifier. Assets from the United Kingdom and Asia, while attractively priced, remained volatile. Leading investors were holding large amounts of cash.

Regent Zettel asked how climate change might affect assets. Mr. Baccher stated that climate change could affect asset prices worldwide. For example, student housing might be hard to insure due to flood or rising sea levels, and real estate in locations like Florida might become less attractive. A sudden price drop could follow a gradual decline.

Managing Director of Public Equity Ronnie Swinkels reported that the U.S. equities outperformed global equities in 2018 and 2019. Technology was a strong performer, growing 46.5 percent. Many UC asset managers exceeded their benchmarks, showing that active management could still add value. The UC Retirement Plan (UCRP) portfolio grew 27.9 percent, and the General Endowment Pool (GEP) grew 30.2 percent. Most market valuations were well above average, with U.S. gains coming from rising valuation multiples. Earnings growth was modest, and, without strong earnings, the U.S. could see a reversal in market performance. Leading technology companies were priced for perfection, meaning their valuations were based on optimistic expectations and could be outperformed. The Office of the CIO has been cautious with equities, but managers still had many attractively priced stocks in their portfolios outside of the U.S. There was a concentrated group of about 20 managers for UCRP and fewer than ten managers for GEP. Mr. Bachher added that 90 percent of asset returns were negative in 2018, and 95 percent of asset returns were positive in 2019. The Office of the CIO reduced 280 key partnerships with asset managers in 2014 to 98 key partnerships in 2020.

Committee Chair Sherman asked whether active managers were meeting their benchmarks. Mr. Bachher replied the Office of the CIO compared a manager’s performance to their own benchmark, the Standard and Poor’s (S&P) 500, and the Morgan Stanley Capital International All Country World Index (MSCI ACWI). The endowment outperformed by 380 basis points, net of fees, relative to the MSCI ACWI.

Mr. Bachher stated that the Office of the CIO has saved over $1 billion in fees over the last five years. Chief Operating Officer Arthur Guimaraes stated that, starting 2017, State law required that public pension plans annually disclose fees paid to alternative investment vehicles. Managers working with UC have complied with the law, and UC now covered 86 percent of its exposure. The Office of the CIO operated at 0.028 percent of costs.

Mr. Bachher stated that UC investments gained $3 billion in value added since 2014. The Office of the CIO had 30 investment professionals who each managed $4.4 billion. Goals for the Office of the CIO for 2019 to 2022 included maintaining relationships with UC campuses; creating relationships in Asia; building on sustainability, diversity, equity, and inclusion; and creating a pipeline for innovation and entrepreneurship. For the next fiscal year, he aimed to create an in-house real estate management company, and he reached out to Regents for guidance. He also designed an investments course with UC Berkeley Haas School of Business that was launching in March. He planned to update UC’s innovation investing strategy and implement a new vision for investing in global strategies.

Regent Makarechian asked whether these goals would be covered in detail. Mr. Bachher replied that he would discuss goals and their progress at future meetings. Regent Makarechian noted that UC had $36 billion in fixed income in the context of total sovereign debt and global real estate and debt. Mr. Bachher stated that there was $11 trillion of negative yielding debt around the world and over-leveraged corporations. The Office of the CIO needed to consider whether to invest in fixed income markets, which were an asset class with lower returns. Regent Makarechian remarked that there was $375 trillion in global debt. Senior Managing Director Steven Sterman stated that, with regard to the aggregate index, which included government bonds, corporate bonds, and mortgage-backed bonds, spreads were tight, duration had extended, and yields were low. It was very difficult to consistently generate the desired alpha in this type of market. The Office of the CIO has been looking for ways to make money with active management. In the credit market, there has been growth and leverage in corporate America. Investment-grade credit spreads had returned to pre-recession levels, BB bonds had very low yields, and a lot of money was being invested into private credit. The Office of the CIO has concentrated on interest rates and sought active investment opportunities worldwide. A portion of core fixed income has been placed in passive equities. The team focused its efforts in areas of the credit market where it could be selective, perform adequate due diligence, negotiate, have financial covenants, and have options if there was a downturn, and it built expertise in private credit, which was an alternative to the commoditized public credit market. Regent Makarechian asked where fixed income, roughly 36 percent of UC investment assets, would be invested and at what rates. Mr. Bachher replied that UC had $12 billion in core fixed income and Treasury Inflation-Protected Securities (TIPS) in the pension and $2 billion in emerging market debt. Regent Makarechian asked whether this debt was mostly in China and India. Mr. Sterman replied that this was U.S.-dollar-denominated sovereign debt from 70 countries. Managing Director of Asia Investments Satish Ananthaswamy stated that monetary policy helped bring down inflation worldwide for several decades, but the absolute level of rates has reached zero, and it was very difficult to generate positive absolute returns in that environment. Pension fund or endowment managers must rethink their strategy for fixed income. Mr. Sterman added that the biggest piece of the $36 billion was core U.S. fixed income, the Bloomberg Barclay’s Aggregate Bond Index (Agg), the pension fund, and the UC Retirement Savings Plan. Instead of trying to outperform the Agg, the team invested a large percentage of fixed income into passive equities, which has funded investments in the credit and rates markets. UC’s net returns on direct transactions and coinvestments has been 9.5 to ten percent.

Regent Makarechian asked whether there was a risk of default in these transactions given the current low interest rates. Mr. Sterman replied that below-investment-grade B exposure accounted for a small part of UC’s credit exposure. A large amount of credit work was done to assess risk, but there was a greater probability of default. The Office of the CIO ensured that debt could be paid despite a recession and that it could intervene if the company did not perform as well. Worldwide liquidity provided many lower-risk options. Mr. Bachher added that private equity firms were buying companies that had borrowed money from UC. Mr. Sterman stated that assumed maturity of these loans was three years, but companies were being bought. The Office of the CIO did not tend to refinance these loans at a lower yield. Mr. Bachher stated that, in light of corporate debt and lower returns, the team has tried private and non-U.S. sovereign debt. Having liquidity as helpful during this time. Real estate investments could be expanded. The Office of the CIO needed to think globally, make use of the investment flexibility afforded to UC, and consider more in-house operations to save money. He called on the Regents for their input.

Regent Um asked whether the Regents Working Group on Innovation Transfer and Entrepreneurialism could strategize with the Office of the CIO. He also asked for big-picture strategies that the Regents could explore. Mr. Bachher stated his belief that university innovation would be a new asset class in the next five years. UC has established itself as a leader in this regard. The Office of the CIO could design ways for UC to implement its strategy. UC had a competitive advantage in venture capital investment in universities. One of the endowment's top performers was a UC-based company.

Chancellor Khosla asked what returns from the retail apartment market would look like. Mr. Bachher replied UC was earning six to eight percent returns on multi-family assets. Chancellor Khosla suggested defining rental property as its own asset class in light of less interest in home ownership, more interest in rental properties, and low interest rates. UC would not have to worry about corporate risk and other issues. Mr. Bachher agreed. Chancellor Khosla stated that, with a real estate investment trust only in rental income, UC would know asset quality, loan quality, and more. Regent Sherman asked whether UC had the economies of scale to do this. Mr. Bachher replied in the affirmative.

Mr. Bachher reported that, as of December 31, 2019, 49 percent of UC's $132.6 billion in investment assets was invested in the stock market, 29 percent was invested in fixed income, and 22 percent was invested in private assets.

Senior Managing Director of Absolute Return Investments Edmond Fong reported that private equity delivered robust returns for the endowment. The market's micro-structure changed significantly, with 60 percent of equity assets held by passive or quantitative funds. With algorithms becoming more prevalent and banks less prevalent, dislocations and volatility were likely, so keeping nine percent in cash could be advantageous. The Office of the CIO aimed to allocate of 30 percent of the endowment to public equity, ten percent to income, and 60 percent to private assets. In the last five years, the Endowment has had $3.5 billion of new inflows, with an additional $630 million projected in 2020.

Regent Sherman asked whether the bulk of those inflows came from philanthropy. Mr. Bachher replied that these were transfers from STIP.

Regent Makarechian asked whether this was the STIP from campuses' working capital. Mr. Bachher responded in the affirmative.

Mr. Fong stated that September was a flat month and that there was more activity in December. The 2020 goals for the endowment included determining how to invest $1.5 billion in private assets, reviewing the implementation of liquidity and opportunistic strategies, providing client service to campus endowment foundations, and helping campuses not currently invested in the endowment.

Regent Sherman asked for data on the performance of campus foundations. Mr. Bachher stated that he would provide a foundation report. Last year, he created a dedicated client service group, which has been visiting campuses. Mr. Guimaraes, who led the group, reported that UC Riverside was the latest campus to move its assets to the GEP. The group was scheduled to visit UC Santa Barbara, UC San Diego, UC Riverside, and UC Santa Cruz, which had moved their assets to the GEP, as well as UC Irvine and UC Davis, which had part of their assets in the GEP. The Office of the CIO has discussed the Blue and Gold Pool with campuses as well. Mr. Bachher added that the Office of the CIO was in contact with the chief financial officers of every campus.

Regent Sherman asked whether the Office of the CIO was aggregating treasury functions for the campuses. Mr. Bachher replied that his team managed a centralized treasury. Campuses had their own treasury functions. Mr. Guimaraes stated that UCLA had a dedicated treasury function, while other campuses incorporated it into their finance office. The Office of the CIO helped campuses with things like cash flow and fraud. A team at the Office of the CIO oversaw $82 billion in cash flows that went to the bank.

Mr. Bachher reported that the Blue and Gold Pool had 10.9 percent net returns since its inception. This was a good alternative for campuses with money in STIP. 2020 goals included investing the endowment into the Blue and Gold Pool, growing assets to $2 billion, and encouraging medical centers to move money from STIP to the Blue and Gold Pool or TRIP. Chancellor Hawgood asked whether the Blue and Gold Pool counted as days of cash on hand. Mr. Guimaraes responded in the negative.

Mr. Bachher reported that net returns for Fiat Lux, UC's captive insurance program, was close to the benchmark. The pension had $74 billion in assets, with fiscal year-to-date returns of about six percent. The long-term allocation for the pension was 50 percent in public equity, 20 percent in fixed income, and 30 percent in private assets. The negative value added was noise. Goals for the pension in 2020 included an asset allocation review and examining implementation consideration.

Managing Director of Defined Contributions Products Marco Merz reported, that, as of September 2019, 320,000 participants invested in the UC Retirement Savings Program, with 90 percent of new hires investing in the target date fund. Of the $27 billion in the program, about 60 percent was in equities, 34 percent was in fixed income, and six percent was in a brokerage window. Participants could invest in mutual funds or exchanged-traded funds if the 14 fund choices were not sufficient. The average management fee was five basis points, well below the fees of other public defined contribution plans. Since the UC Retirement Choice Program began in 2016, 37 percent have elected Pension Choice, 36 percent elected Savings Choice, and 27 percent defaulted to Pension Choice. In the Savings Choice Program, the Office of the CIO has built a target date fund that addressed accumulation risk and sequencing risk. Remaining risks included longevity and deciding how to spend the retirement income. The Office of the CIO has collaborated with the Academic Senate to educate participants. The UC Retirement Savings Program aimed to allow participants the option of purchasing a deferred annuity at age 62, which would be important for those who elected Savings Choice and did not have access to UCRP.

Chancellor Hawgood asked whether there was a difference between the demographics of those who chose Pension Choice and those who chose Savings Choice. Mr. Merz replied that more individuals with a lower salary elected Savings Choice. Those younger than 40 years of age tended to elect Savings Choice, while those between age 40 and 55 tended to elect Pension Choice. He offered to share choice pattern data.

Regent Park requested to see a comparison of retirement savings elections at UC medical centers with elections at other UC locations.

Faculty Representative Bhavnani remarked that individuals under 40 years of age would elect Savings Choice because it was portable. Mr. Merz stated that portability, flexibility, and the shorter vesting period were factors. The Savings Choice vesting period was one year, while the vesting period for Pension Choice was five years.

Regent Sherman asked whether employees were presented the assumed rates of return for Savings Choice and Pension Choice to help them with the decision. Mr. Merz replied that there were robust education materials designed with models that projected into the future. New hires had ample information to make an informed decision. The Office of the CIO wished to reduce the number of employees who did not make a choice.

Mr. Sterman stated that the interest rate cuts by the Federal Reserve (Fed) extended the credit cycle and showed its desire to encourage inflation. The Office of the CIO did not expect a large increase in inflation in the near future. TIPS was not a long-term, strategic allocation, but rather a tactical trade within core fixed income portfolios. TRIP's exposure in public equity was trimmed by two to three percent because of market rise from October to December and outflows to campuses to fund projects. Significant overweight to credit within TRIP's income allocation was reduced to limit risk. The Office of the CIO terminated two of three absolute return managers, and much of that money went into cash. The asset allocation for TRIP was 35 percent public equity, 50 percent public income, and about five percent each for absolute return, private assets, and cash. TRIP saw fiscal year-to-date net returns of 4.5 percent. Goals in 2020 for TRIP were reviewing the asset allocation, examining implementation, and developing strategies for public income and moving to 90 percent passive implementation. As of December 31, 2019, STIP had above-average levels of commercial paper, significant maturities, and large campus cash flows. STIP had fiscal year-to-date net returns of 1.2 percent with 30 basis points of value added as a result of the Fed reducing interest rates.

Advisory member Zager asked whether nominal rates of return needed to go from flat to positive in order for U.S. real rates of return to go back to positive numbers. Mr. Sterman replied that Europe transitioning from fiscal stimulus to monetary stimulus and central banks going to zero would drive interest rates in the U.S. The market priced in more inflation in the last few months, but priced inflation was still trading lower than delivered inflation, so the Office of the CIO tactically bought TIPS.

Mr. Bachher invited Committee Chair Sherman and other Committee members to provide input on developing the concept for the Office of the CIO's real estate management company before the next Committee meeting. At the next meeting, he would discuss the asset allocations of TRIP, the endowment, and the pension, as well as implementation of the endowment. He would also provide an update on innovation strategy.

Regent Makarechian asked whether UC was limited from investing in its own innovations. Mr. Bachher replied that, with the proper structure, there were no limitations that he was aware of. UC co-founded Bow Capital, which had a team that focused on investing in UC companies. The Office of the CIO was a capital provider at multiple campuses. Regent Makarechian recalled that, in the past, money from chancellor's funds were allocated to deans, who chose the professors and projects. Each campus' office of innovation and technology decided whether to spend money on patents. At the time, projects were running out of money, so then former President Yudof provided funding through the Office of the President. Mr. Bachher stated that the Office of the CIO participated in commercially designed funds as a limited partner but did not invest in technology transfer. The Office of the CIO had no limitations when working with third-party funds or entities that had left the University sphere. Regent Leib added that this was an area of focus for the Regents Working Group on Innovation Transfer and Entrepreneurialism.

Mr. Bachher reported that the Office of the CIO decided to hold more cash in September 2019, increasing holdings from five percent to ten percent, in anticipation of market changes that did not happen. He still believed that it was good to be defensively postured.

Mr. Guimaraes introduced Wendy Pulling, Director of Environmental, Social, and Governance (ESG) Integration at the Office of the CIO. Diversity efforts at the Office of the CIO began in 2015. Since then, he and Ms. Pulling have attended conferences and met with peers, emerging managers, and advocacy groups, who asked why the Office of the CIO was making an effort to improve diversity. One reason came from Regents Policy 4400: Policy on University of California Diversity Statement, which explained how diversity advances the UC mission. A study by the Knight Foundation concluded that the industry was not diverse and that diverse teams performed the same or better. The Office of the CIO surveyed the leaders of U.S.-based firms that held $90 billion of UC investment assets, and 90 percent responded. In the survey, "substantially diverse" meant 25 to 50 percent diverse-owned, "majority diverse" meant 50 percent diverse-owned or more. Out of 106 firms, 63 were not diverse, meaning less than 25 percent diverse-owned, and 35 firms were substantially or majority diverse. Of those, there were 14 women-led firms, three African American–led firms, and one Latino(a)-led firm. The Office of the CIO developed a strategy for its roles as employer, asset manager, and shareholder. As an employer, it needed to write inclusive job descriptions, cast a wider net when recruiting, and reach out to advocacy groups when posting jobs. As a shareholder, this meant advocacy through shareholder votes and being more specific about its values as a shareholder. The Office of the CIO practiced intentionality by focusing on these values of diversity, equity, and inclusion as an employer. Being accountable meant being transparent. The team had worked directly with then State Assemblymember Anna Caballero on Assembly Bill 2041, which urged the Regents to require that the Office of the CIO use reasonable efforts to encourage diversity. Being integrated meant applying this approach to all asset classes.

Committee Chair Sherman asked about diversity in the total universe of investment managers. Mr. Guimaraes replied that there was not much available data and estimated nearly ten percent diversity. Mr. Bachher was confident that the number of diverse private equity firms would be quite small. Ms. Pulling added that the U.S. asset management industry was worth $69 trillion, of which 1.3 percent was managed by firms owned by women or people of color. Committee Chair Sherman stated that UC was demonstrating its leadership in this regard despite having more progress to make.

Regent Park expressed disappointment about the fact that so little on the report that the Office of the CIO had submitted to the State Legislature was included in this presentation. She asked whether the pilot program mentioned in the report resulted in a diverse hire. Mr. Guimaraes responded in the affirmative, adding that, because an applicant pool was not diverse when the job was first posted, the Office of the CIO edited the job description and worked to diversify the applicant pool. Mr. Bachher stated that, while the Office of the CIO got better at casting a wider net, it hired the best candidate irrespective of background. He challenged his asset class leaders to cast a wider net but also to hire based on performance.

Regent Park, referring to the report to the Legislature, asked about the lower percentage of women in workforce diversity trends compared with that of 2015. Mr. Guimaraes replied that the Office of the CIO had exceeded its 2015 numbers after the report was released. There was nothing to suggest why the numbers changed as they did. Mr. Bachher stated that 280 key partnerships had been reduced to 98 since 2015. Performance has been the driver. He was open to discussing whether to set goals and targets for the Office of the CIO, but it was still too early to see results. For example, there were currently eight managers in public equities and the endowment, so adding one would be significant. Asset leaders were challenged to expand the universe from which to search for that one manager.

Regent Park noted the small percentage of Latino(a)-owned and black-owned firms, as well as the small percentage of Latino(a) and black staff at the Office of the CIO. She stated that the focus should be on increasing the number of these firms. Ms. Pulling added that the Office of the CIO should also increase the number of women-owned firms. Regent Park asked when the Office of the CIO would execute its goals, such as creating an advisory committee or providing unconscious bias training. Mr. Bachher stated that the diversity advisory committee was created last year and had met several times already. Thasunda Duckett of JP Morgan Chase, Maverick Carter, and Regent emerita Monica Lozano were co-chairing the committee. Regent Park asked what the committee has been asked to do. Mr. Bachher replied that the committee helped him understand relevant issues. Regent emerita Lozano shared what she has done to diversify boards and foundations. Ms. Duckett has developed career pipelines at JP Morgan Chase. Mr. Carter explained the challenges that millennial Latino(a) and black entrepreneurs faced. The Office of the CIO could be a platform, connecting students with investment partners and making a scalable impact. Mr. Bachher acknowledged that the Office of the CIO's current diversity numbers were low, and he underscored the importance of understanding its current position in order to make progress. He anticipated that the Office of the CIO would lead in diversity as it has led in climate action. Regent Park expressed her hope that Mr. Bachher's staff would complete the unconscious bias training by the end of the calendar year.

Regent Park suggested that the Office of the CIO regularly share what it has learned from its diversity advisory committee. Mr. Bachher stated that Provost Brown and Interim Vice President Gullatt also attended the diversity advisory committee meetings, which ensured communication between the Office of the CIO and the rest of the University. Building a pipeline with schools could address the gaps in the industry.

Regent Anguiano stated that the Office of the CIO needed to set explicit goals. Mr. Bachher asked the Committee for guidance on how it defined success.

Regent Makarechian suggested comparing the returns of women- and minority-owned funds. Mr. Bachher stated that he could share that data.

Committee Chair Sherman asked whether the Office of the CIO could generate some of this data given that much of it was not readily available. Ms. Pulling stated that UC was the first to conduct such a survey and make it public. In committing to release numbers every year, UC was leading the industry. Mr. Bachher added that Blackstone launched a website on climate change and diversity, equity, and inclusion. UC's actions were encouraging others to do the same.

Faculty Representative Bhavnani asked whether the Office of the CIO provided mentorships or internships to UC students with a view toward issues of diversity and income inequality. Lower-income people were not confident in their understanding of money. Mr. Bachher replied that solutions needed to be scaled in order to provide access for more students. Since Mr. Bachher joined UC, the Office of the CIO has mentored 40 UC students. It was also sponsoring a fellowship program that would send 30 UC students to attend the Lindau Nobel Laureate Meetings in science and economics. Campuses were asked to select students who reflected California's diversity. He hoped to grow the program in order to broaden the Office of the CIO's reach. He asked that campuses contact the Office of the CIO with partnership opportunities.

The meeting adjourned at 4:35 p.m.

Attest:

Secretary and Chief of Staff