The Regents of the University of California

INVESTMENTS COMMITTEE
May 19, 2020

The Investments Committee met on the above date by teleconference meeting conducted in accordance with Paragraph 3 of Governor Newsom's Executive Order N-29-20.

Members present: Regents Blum, Cohen, Elliott, Leib, Makarechian, Napolitano, Park, Sherman, Simmons, Um, and Zettel; Advisory member Bhavnani; Chancellors Hawgood, Khosla, and Wilcox; and Staff Advisor Klimow

In attendance: Regents Kieffer and Weddle, Regent-designate Muwwakkil, Faculty Representative Gauvain, Secretary and Chief of Staff Shaw, Deputy General Counsel Woodall, Chief Investment Officer Bachher, Executive Vice President Byington, Interim Executive Vice President and Chief Financial Officer Jenny, and Recording Secretary Li

The meeting convened at 1:15 p.m. with Committee Chair Sherman presiding.

1. **APPROVAL OF MINUTES OF PREVIOUS MEETING**

Upon motion duly made and seconded, the minutes of the meeting of January 21, 2020 were approved, Regents Blum, Cohen, Elliott, Leib, Makarechian, Napolitano, Sherman, Simmons, Um, and Zettel voting "aye."[1]

2. **UPDATE ON UNIVERSITY OF CALIFORNIA INVESTMENTS PRODUCTS – RETIREMENT, ENDOWMENT AND WORKING CAPITAL**

[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 began the presentation by explaining how the Office of the CIO's ten guiding principles, The UC Investments Way, have helped the Office of the CIO make decisions and grow UC investments. As of May 18, 2020, UC managed $125 billion in investment assets. Global public equity markets fell 34 percent in February, and UC assets decreased by $14 billion in the third quarter of fiscal year 2019–20. Markets have since rebounded with the help of fiscal stimulus from governments around the world, and UC assets rose from $119 billion to $126 billion at the end of April.

Mr. Bachher summarized UC investments performance as of May 18, 2020. The key driver of long-term performance has been the stock market. The pension has had 7.7 percent returns in the last 25 years and 4.5 percent returns in the last five years. Returns were lower because interest rates have dropped to nearly zero in these 25 years, and increased

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

government stimulus could mean that interest rates remain at zero for an extended period of time. The endowment has had 8.4 percent returns in the last 25 years and 5.6 percent returns in the last five years. The Office of the CIO aimed for eight percent returns for the endowment. All that has happened in the markets in the last three months has not been reflected in UC investments on a one-year basis.

Currently, UC had nearly $60 billion in stocks and bonds in a variety of indices and was actively managing $65 billion. Mr. Bachher predicted that indexed investments could grow by $15 billion in this calendar year. Actively managed assets have generated $5 million in value added over the last six years: $3 billion in the pension, $1.4 billion in the endowment, $400 million in working capital, and $200 million in retirement savings. The COVID-19 pandemic led to a drop of 34 percent in the markets, the fastest since the Great Depression, as well as a rebound of 20 percent in one month. There were many unknowns in the future. In Mr. Bachher's view, financial sustainability and survivability would be determined by liquidity. In the last few years, the University earned money through its cash holdings and went into the pandemic with roughly $15.6 billion in liquidity from various investment products. The Office of the CIO has continued to increase liquidity in light of what seemed like unstable markets, and, in April, it helped provide more liquidity to campuses to respond to the pandemic. The Office of the CIO has positioned itself to have $8 billion in unfunded commitments to companies, about $750 million for endowment and working capital payouts, and nearly $20 billion for investing in attractive opportunities in the markets for the pension and the endowment. The Office of the CIO would continue to partner with the Regents and UC administrators to work through this crisis.

Committee Chair Sherman asked about net inflows and outflows for the endowment during the period that was presented. Mr. Bachher replied that, in the last six years, there has been $3.5 billion of inflows, with $1.4 billion of value added, and the rest was growth.

Committee Chair Sherman asked about the University's exposure in the fossil fuel asset class, given what has happened in the energy markets. Mr. Bachher replied that the Office of the CIO announced that the endowment was free of fossil fuel investments in September 2019. As of today, the pension and all working capital pools were also free of fossil fuel investments, which meant that the University's $125 billion of investment assets were all free of fossil fuel investments.

Regent Makarechian asked what UC's retirement funding ratio was. Mr. Bachher replied that it was about 74 percent. Last fiscal year, the ratio was about 81 percent. Regent Makarechian remarked that lowering the discount rate would lower the investment performance requirements and also lower the funding ratio, and employers and employees would have to contribute out of pocket. He asked whether the University would have to lower the discount rate if it does not invest its cash and earn large returns. Mr. Bachher replied that the asset allocation of the pension was 50 percent stocks, 20 percent bonds, and 30 percent private assets. At present, the pension was approximately 40 percent stocks, 20 percent bonds, 21 percent private assets, and the balance in cash. With interest rates and government stimulus suggesting returns for fixed income close to or at zero for the foreseeable future, conservative assets like cash or bonds would earn nothing. He agreed that he would not be able to achieve the previous discount rate. The short-term performance of the stock market remained unknown. Ensuring that capital was available to invest when the markets drop and prices are more attractive was a defensive action. It has been a lower return environment for several years. Both investments and contributions were needed to maintain a funding ratio.

Regent Makarechian stated that contributions from the State, the University, or employees were unlikely under current circumstances. Holding $20 billion, or 40 percent of UC investments, in secure assets with no returns would force the other 60 percent of investment assets to perform twice as well in order to achieve the desired rate of return. He asked how the Office of the CIO would achieve that. Mr. Bachher replied that holding this amount of cash was tactical positioning rather than a strategic posture. The risk profile in the stock market was asymmetric; there was an upside but potentially more of a downside to investing in the short term. Opportunities were priced for the current landscape, not the one of the future. Mr. Bachher preferred to have capital available to invest and to take advantage of opportunities when they arise rather than later having to liquidate investments for capital.

Regent Makarechian expressed his concern that the UC investments would not make much money in the next two years. Mr. Bachher replied that, historically, a pension plan and working capital had fixed income in bonds so that there was liquidity available. There were times when U.S. Treasury bonds did not trade. In March and April, the Office of the CIO worked to make liquidity available to meet future needs. In the last five years, taking fewer risks has not been a disadvantage for the University. This would not be a long-term position. Having accounted for risk, the Office of the CIO was looking for new opportunities.

Committee Chair Sherman asked whether UC was positioned to take advantage of a downturn, such as a short position or a hedge on the negative performance of the equity markets. Mr. Bachher replied that the cash position was acting as a hedge. He was surprised that some hedge funds had fared worse than the markets. Cash had been a good hedge until recently, with government stimulus and zero percent interest rates.

Regent Um asked for Mr. Bachher’s opinion on hardship distributions from retirement plans, which was subject to a Regents’ vote at another meeting. Mr. Bachher replied that people needed cash to sustain themselves. Regent Um noted that some companies had already begun hardship distributions through the Coronavirus Aid, Relief, and Economic Security (CARES) Act. He asked what the loan and distribution rates were. He observed that people were being solicited to take advantage of these distributions as a market hedge and asked what effect this would have on long-term retirement savings. Mr. Bachher responded that the UC Retirement Savings Program has provided options to take out distributions. In March, UC retirees began to withdraw money from the UC Retirement Savings Program at rates of $13 million to $15 million per day. On March 20, the Office of the CIO hosted a webinar that encouraged its 3,000 attendees to stay the course, and the amount withdrawn declined. As of May 18, $400 million has been withdrawn from a base of $25.5 billion in the UC Retirement Savings Program. This was an indicator of how people were reacting to the markets. He believed that cash and sustainability were the only ways to address the financial issues resulting from the pandemic. People should consider all possible sources, access them, and have control over them.

Regent Zettel asked whether the Office of the CIO sold short as a hedge. Mr. Bachher replied that some hedge funds had long-short strategies. The Office of the CIO had several managers with these strategies, but they were part of an overall portfolio with different kinds of defensive investments. In Mr. Bachher's opinion, some of the best hedges to this crisis have been long positions in China, biotechnology and healthcare, and companies such as Amazon, Facebook, Google, Netflix, and Apple. These were not intuitive hedges. Not investing in oil and gas has been a good decision during the last few months. The portfolio positioning that has benefited UC was unexpected, so remaining diversified and balanced would be more helpful than looking for the perfect hedge. Human behavior, such as holding on to stocks for too long, could affect the success of a hedge. In the long term, UC should be fully invested, but this was a time of uncertainty. Stock indices suggested that stocks were highly valued, which was new regardless of the pandemic. Mr. Bachher was looking for long positions that would benefit from the post-pandemic world. For example, commercial real estate had become a challenging investment, while data centers have performed very well in the last several months. He wished to leverage the University's competitive advantage in healthcare, knowledge, and technology.

Regent Leib asked about the Office of the CIO's efforts in diversifying its staff and investment managers, noting that certain groups felt shut out of this arena. Mr. Bachher replied that, in the last several years, the Office of the CIO has been evolving its environmental, social, and governance frameworks in its portfolio. The demographic survey that the Office of the CIO released last year was acknowledged by industry leaders. The Office of the CIO was very far from what Mr. Bachher considered success in diversity. In his view, success was driven by good performance, which studies have shown correlates to diversity. In the last quarter, the Office of the CIO had hired a new public equities manager in the small cap arena. The COVID-19 crisis has shown that communities were affected unequally. The Office of the CIO sought investment opportunities that would make a positive contribution to communities and would work to add more African American and Latin American managers. There was already a strong roster of Asian American managers and women-led teams.

President Napolitano acknowledged the Office of the CIO's success in becoming free of fossil fuel investments. This had been a longtime goal that was aligned with other positions taken by the University.

Chancellor Hawgood asked when the University should access debt markets for upcoming major capital projects if the pandemic resolved in the next two years. Mr. Bachher replied that the debt markets should be accessed now. The Federal Reserve had injected large sums of money into the economy, and there were record issuances in corporate debt in the last two months. If businesses shuttered by June or September, Mr. Bachher predicted more economic damage. One bankruptcy restructuring company that typically watched 20 companies at risk of bankruptcy was now watching 120 companies. The fact that companies were being starved of revenue for six to 12 months was more damaging to the economy than the healthcare crisis. Mr. Bachher advised the University to take advantage of the available debt in the market.

Regent Makarechian remarked that a fundamental change had occurred. There was no longer the same need for office buildings, hotels, and large convention spaces. Major brands, department stores, and malls were going bankrupt. UC should be focusing on investment opportunities that provided the highest returns for years to come. Mr. Bachher agreed with Regent Makarechian's remarks. The University was positioned off benchmark in response to changes in the world, and it should determine the new benchmark and invest heavily in growing sectors. Avoiding the temptation of investing and holding cash for the last five years meant that UC's portfolio did not need to be revised to prepare for the post-pandemic future. He predicted that there would be investment opportunities in digital technology, healthcare, biotechnology, and new delivery systems, and many opportunities would be in the U.S. Regent Makarechian noted that, in determining asset allocations and future opportunities, UC must consider how the future would look. Mr. Bachher stated that the virus has accelerated the demise of a number of traditional industries. The work of the Office of the CIO was to invest, not to benchmark.

Regent Makarechian asked whether there were restrictions to investing that the Regents could remove. Mr. Bachher responded in the negative. Regent Makarechian stated that the Office of the CIO was prohibited from investing in certain UC projects, such as student housing. Mr. Bachher clarified that there were no restrictions in terms of governance and the relationship between the Office of the CIO and the Committee. The Office of the CIO had flexibility in decision-making and positioning. Creating a real estate management company to house those projects would prevent conflicts of interests. There would be workable solutions if there was an attractive project. He would come to the Regents if he came across any limitations or restrictions.

Regent Weddle suggested creating measurable equity goals so that the Committee could see the Office of the CIO's progress. Mr. Bachher replied that a measureable goal would be increasing investment performance with African American and Latin American managers. The Office of the CIO would report on the success of that pool of assets. As with divestment from fossil fuel companies, every investment decision must be assessed for its financial risk or opportunity. Regent Weddle added that Regents should be informed of the time it would take to reach those equity goals.

Committee Chair Sherman suggested that the Office of the CIO would report semiannually on its progress in diversifying its managers by working from the report presented to the Regents at a previous Committee meeting.

Regent Park stated that, given the volume of materials for every meeting, it was important to highlight achievements in diversity and to strongly commit to UC values especially at this time. She looked forward to seeing a robust report. Mr. Bachher responded that all of these issues were important. Industry leaders who were passionate about diversity used the Office of the CIO's demographic survey to reach out to presidents of Ivy League universities. Reverend Al Sharpton has also referenced the report. UC was being public and transparent. Because of the pandemic, Mr. Bachher wished to focus this meeting on the sustainability of the financial institution. He would continue to share information about diversity in real time. Regent Park noted that there seemed to be many opportunities for UC to lead based on its core values. Including these issues in UC meetings would indicate that the University prioritizes them.

Regent Simmons also asked that the Office of the CIO's diversity, sustainability, and divestment efforts be presented more often than just semiannually. These efforts were especially important during the pandemic, because some populations would be disproportionately affected and would need meaningful investment in them. Mr. Bachher replied that diversity efforts were a daily practice at the Office of the CIO, which was seeing the pandemic's effects on communities of color in real time. He hosted a series of conversations with UC leadership regarding the University's response to the pandemic. In June, he would host a question-and-answer series on diversity, equity, and inclusion.

Faculty Representative Bhavnani shared research from UCSF indicating that 95 percent of the Latino(a) population in the Mission district in San Francisco could not work from home. She asked whether institutions of higher education have used borrowing or refinancing as a strategy to tackle the financial emergency that many institutions were facing. Mr. Bachher replied that there were other institutions of higher education that have raised money in the debt markets and that UC has frequently done so as part of its debt strategy when it had the capacity. From a long-term perspective, interest rates were currently very attractive. It would depend on an institution's credit rating and cash needs. Ms. Bhavnani asked whether this could be a strategy for the University. Mr. Bachher replied that Interim Executive Vice President and Chief Financial Officer Jenny and President Napolitano have been discussing it. He believed that continuing to raise debt capital would be an important strategy to consider.

Committee Chair Sherman asked whether there were trends within the UC Retirement Savings Plan and whether employees who could self-direct their money made any major moves. Mr. Bachher replied that, from March to the present time, half of $400 million withdrawn by participants came from target date funds and the other half came from other funds. Withdrawals accelerated through March 20, declined thereafter, and began accelerating again in the last two weeks. He had observed unprecedented levels of activity from retail investors in the rising equity markets. Participants' brokerage accounts were handled by Fidelity Investments Inc. The Office of the CIO aimed to communicate with participants about their options and about staying calm in the long term.

Committee Chair Sherman asked whether people experiencing hardship could borrow from their retirement savings plan or make hardship withdrawals. Mr. Bachher responded that legislation was enacted that allowed participants to withdraw up to $100,000 from their retirement savings plan and was being considered by the Regents.

Regent Makarechian confirmed that such withdrawals were being considered at the Finance and Capital Strategies Committee meeting. He congratulated Gloria Gil, Senior Managing Director at the Office of the CIO, on her retirement.

Committee Chair Sherman echoed Regent Makarechian's congratulations to Ms. Gil and commended Mr. Bachher and his team for the work they had done during the pandemic. The University's investments performance was still surpassing the benchmarks.

Mr. Bachher asked Regent Makarechian in what sectors he was seeing investment opportunities. From an asset allocation perspective, investments in the pension and endowment were overweight in cash. Regent Makarechian suggested a separate meeting to discuss new opportunities. For example, Airbnb and rideshare companies were no longer leaders in their industries. Now that the University has divested from fossil fuels, it could consider investing in real assets in hydroelectricity. In his opinion, large hotels in major cities would become passé. He underscored that the world had changed. The pandemic had done away with many movie theaters, and a developer might turn them into residences. The University needed to consider how to invest in the next 15 or 20 years.

Regent Leib noted that commercial real estate seemed like a very risky investment as there would be less need for as much office space.

Mr. Bachher stated that a structural shift was taking place in the world that required the University to rethink its best opportunities. He rested assured that UC was positioned to invest in the opportunities of the future. He recognized his team and emphasized the final guiding principle of the UC Investments Way, "centennial performance."

Regent Blum shared that his company was buying land and leasing it back to properties on that land over 25 years to 100 years. There was a market for this, and the returns were good.

The meeting adjourned at 2:45 p.m.

Attest:

Secretary and Chief of Staff